Lockton Construction & Design Market Outlook

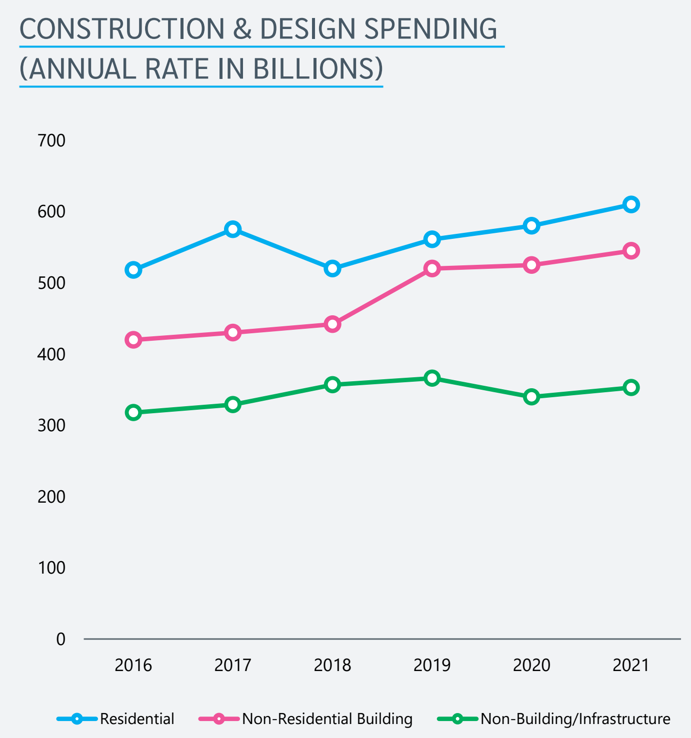
May 2021

The year 2020 will be remembered for decades to come, especially for the unique challenges that it presented. Overall spending within the construction and design industry was down as compared to its 2019 results. A majority of this decrease was attributable to the temporary stoppage of ongoing projects and the delay in finalizing future project starts.

As we proceed through 2021, most economic analysts agree key areas of the construction and design industries will remain below prior-year results.

Construction & design spending

As compared to 2020, it is expected that total spending for 2021 will decrease in a range of 1% to 4%, driven predominantly by the commercial building sector.



Data source: FMI Engineering and Construction Outlook

These overall estimates include:

- Positive residential construction growth.
- Stable to decreased growth within the non-residential building segment. This decrease is driven by areas such as office space, hotel and amusement/recreation.
- Stable results within the non-building segment (especially infrastructure and public safety projects). The promising news is developing within this segment with the announcement of President Biden's $2 trillion infrastructure plan. Projects related to bridges, water supplies and underground utilities could see helpful increases within any final proposals.

Project backlog

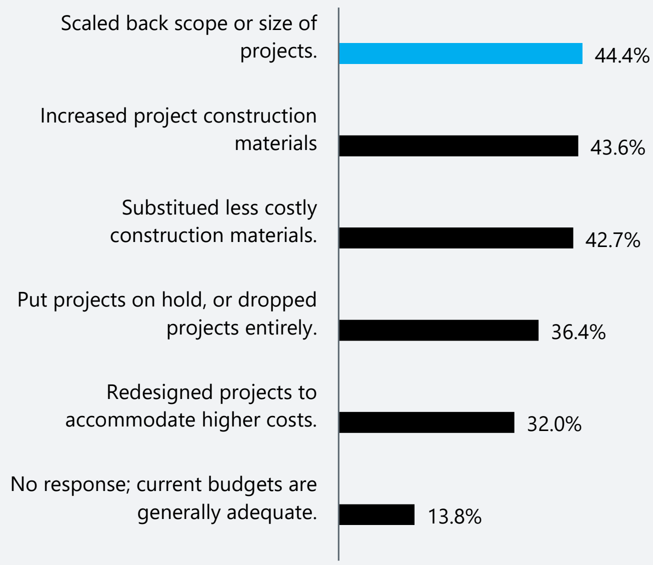
With the predicted decrease of spending and project starts, overall starting backlogs for 2021 are forecast to decrease 8%-10% compared to the previous year. This adverse trend is also expected to continue into 2022 as commercial project starts and size increase.

Factors to consider

RECOVERY FROM COVID-19. 2021 will bring forth vaccinations that should provide operational and economic recovery to the construction and design industry. As the recovery process continues, the industry is prepared to target concentration within project areas of expected growth.

However, the ability to source raw materials and the manufacturing of building supplies must be closely analyzed. In some cases, the rising costs of materials caused by limited availability have resulted in changes to ongoing projects. A late 2020 AIA ABI Survey on rising building material costs showed a slight majority of respondents experiencing a diminished scope and size of projects.

EFFECTS OF RISING MATERIALS COST & LIMITED AVAILABILITY



Data source: American Institute of Architects - ABI Survey - November 2020

FINANCIAL AND PROFITABILITY PRESSURES. It will remain vital that construction and design firms seek other ways to maintain profitability in 2021. Entities must remain vigilant in fully understanding their contractual risks, especially new exposures that may be present in the post-COVID era. It is also vital that organizations continue to implement strong supplier and subcontractor management tools and reviews.

GREATER USE OF TECHNOLOGY. As part of the process of remaining profitable, industry leaders may invest further into technology tools that provide greater efficiency, productivity and worker safety. Real-time data analytics with tools such as Building Information Modeling (BIM), wearable safety sensors and water monitoring systems can help uncover new areas of focus within projects that may benefit from a greater streamlined approach and automated processes. It is predicted this technology will provide entities with greater measurement tools and the ability to make proactive decisions.

Construction & design insurance market

Workers' compensation

It is expected that insurance markets will continue to seek a broad appetite within the workers' compensation area. Guaranteed cost risks experienced flat pricing during the fourth quarter of 2020, while early 2021 renewals showed a positive median rate change for the first time in five years. Meanwhile, the loss-sensitive marketplace moved back to near-flat after showing a nominal positive median rate change in the prior two quarters.

Workers' compensation losses related to COVID-19 remain ongoing and continue to evolve. In many situations, individual states continue to create specific workers' compensation presumption acts, which place the burden of disproving exposure-related losses upon the employer. Carriers are still unsure of the full impact of the disease or its potential to contribute to chronic illnesses or future disabilities. It is also unclear as to how permanent partial disability awards may be established.

Adjusting the combined ratio to accident year basis illustrates losses are trending higher and premiums are failing to keep pace. Carriers have also eroded reserve redundancies, placing more pressure on risk selection and pricing. As a result, the continued use of data analytics to identify key loss drivers will remain vital in implementing targeted strategies to proactively managing future losses within an entity's workers' compensation program.

General liability, automobile, excess liability

Primary

Primary rate increases for commercial general liability insurance programs have ranged 10%-15%, while commercial automobile is projected to continue higher rates of 15%-20%. Beyond expected firming of rates, larger retention size and narrowing of coverage terms may also occur.

Risks associated with exposures to wildfires, New York labor law, residential/construction defects are all under selective underwriting scrutiny. However, there is potential promising news that the state of New York is considering creating a much-needed statute of repose to limit when allegations of construction defects may be pursued. In its current proposed legislative form, the statute would impose a 10-year limitation period after completing a construction project that legal action may be asserted against a contractor. New York remains the only state without a statute of repose for construction.

Residential construction

The residential market continues to be extremely limited, particularly in California, Arizona, Nevada and Florida, due to higher than average litigation. Both Washington and Texas are also being closely watched for potential trends in this same area.

Traditional general liability and excess coverage forms continue not to provide complete solutions to the exposures faced by the homebuilding industry. This is especially true with the exodus and nonrenewing within many large builder primary markets and the reduction in capacity in specific program business. As a result, large-volume homebuilders are continually challenged with finding long-term insurance partners.

The use of wrap-up programs are effective coverage programs for premises operations during construction and extended completed operations coverage through the state statute of repose.

Controlled insurance programs

WRAP-UP INSURANCE (OCIP/CCIP) IS EXPERIENCING A PRIMARY GENERAL LIABILITY RATE PUSH IN THE 10% AREA FOR NON-CONDOMINIUM PROJECTS. Despite the seeking of rate increases, coverage terms remain consistent. Rolling owner and contractor-controlled insurance programs also remain available.

Pricing and capacity of excess coverage for wrap-ups remain a challenge through 2021. It is critical to understand potential delays of project schedules at the inception of coverage to ensure capacity remains toward expiration where extensions are typically requested.

For owners and contractors working on projects in New York state (and more specifically, New York City), the wrap-up market continues to be a viable option for larger construction projects. With the exception of a recent addition to the market, all carriers writing two-line wraps in New York are requiring fully fronted primary general liability insurance programs with excess markets looking at $3 million - $5 million attachment points. As a result of this market condition, contractor-sponsored wrap-ups have become more advantageous for owners building midsized projects as they are able to leverage the volume of multiple projects to satisfy the large retentions and fronting requirements.

Whether placed through a rolling program or project-specific placement, wrap-ups continue to be the choice for owners, contractors, lenders and other financial stakeholders for coverage certainty that extends completed operations through the state statute of repose.

Controlled insurance placement strategies

THE MOST PREVALENT ISSUE ON WRAP-UPS HAS BEEN LIMITED EXTENSIONS FOR SIGNIFICANT PREMIUMS, OR WORSE NOT OFFERING EXTENSIONS AT ALL. A few pre-placement strategies that may alleviate future project extension challenges.

- Consider the use of three- to six-month extensions before binding coverage, subject to specific project circumstances or changes that would dictate the additional premium charge:
  - Delay due to unforeseen circumstances
  - Delay due to weather
  - Delay due to a builder's risk loss
  - Delay due to change orders
  - Delay due to change in design or scope of work
- Look to insurers that have extensive wrap-up underwriting experience and consistency in the market. This may not always be practical for some projects (such as residential exposures), but for large commercial projects, look to the admitted market first.
- Review completed operations wording that triggers coverage for when final certificate of occupancy (FCO) is received. In many instances, the projects are "substantially completed" and receive a temporary certificate of occupancy. An FCO may take months to obtain that may require an extension.
- Understand the construction budgets (general contractor and owner) and construction schedules. Drill down the construction costs, especially the soft costs and business income. This is invaluable when delays result from a covered cause of loss, and extension premiums are an itemized soft cost under the builder's risk delay in completion coverage.

Umbrella/excess

For 2021 the excess markets continue seeking premium increases, higher attachment points, reduced limits and quota sharing. Rates are expected to grow in the 15%-50% range, which further demonstrates the excess market volatility.

A sampling of placements for the period of October 2020 through January 2021 showed that a median increase for lead excess was 16% and the average increase was 22%. The median excess increase was 23%, and the average increase was 32%. **In addition to rate increases, the following trends are being detected:**

- Some markets may also look to reduce automobiles to 100 unit (standard commercial) and/or 25 (heavy vehicles).
- More markets are including pandemic and wildfire exclusions for contractors.
- Lead umbrella attachments are increasing to $2 million - $5 million for automobile risks depending on fleet size. Primary general liability insurance limits are increasing to $2M/$4M/$4M, placing additional pressure on the reinsurance market.
- The previous $25 million lead umbrella limits are reduced for contractors to the $10 million - $15 million range.
- The number of umbrella markets requiring underlying supporting policies has increased, while markets considering unsupported business will have stricter requirements on attachment points and pricing.

Builder's risk

THERE CONTINUES TO BE DEMAND AND CAPACITY IN THE MARKETPLACE FOR NON-WOOD FRAME CONSTRUCTION PROJECTS, both on a stand-alone basis and for master builder's risk programs. Non-wood frame projects are experiencing moderate rate increases, and increased deductibles as carriers look to sustain profitability. In particular, water damage deductibles are being applied across all construction types. Risks such as vertical construction projects are likely to incur a minimum water damage deductible of $100,000.

Many major insurers have revised their underwriting practices and principles with a view to reducing exposure. As a result, reduced line sizes are now being offered on larger projects by these key insurers. Furthermore, they are now basing their line sizes on total insured values (TIVs), rather than probable maximum loss (PMLs). This has resulted in reduced line sizes being offered in some situations.

For projects in CAT locations, wind and earthquake deductibles are typically 5%/$250,000 minimum. Deductible buydowns are available in both the excess and surplus lines marketplace. Flood is trending away from flat, non-percentage deductibles for floods, such as $100,000 for 500-year flood zones and $250,000-$500,000 for 100-year zones. Instead markets are now offering percentage deductibles similar to "named windstorms" with a 1% to 5% of values at the time of loss (VATOL) subject to minimum deductibles of $100,000 to $250,000. In addition, when storm surge is included in the definition of flood, some markets are amending terms and moving it to be included in Named Windstorm for projects in specific high-hazard locations.

Owners, developers and general contractors with robust pipelines should consider master builder's risk programs to save on overall costs, increase ease of administration/budgeting, and obtain consistent coverage. Master builder's risk programs can also be a competitive advantage when bidding on projects. However, due to the changing market, multiyear MBR programs can be challenging to locate. With excess DIL pricing quickly increasing, quota-share approaches may be the most cost-effective for large CAT-exposed projects.

The wood frame builder's risk market continues to harden at a rapid pace. Recent losses from extreme weather events and civil unrest continue to force markets to increase rates, require additional security and safety measures, and increase deductibles.

On all projects, markets are looking for more robust site security measures, including:

- Site lighting (possible motion sensors).
- Fenced and locked 24/7.
- Cameras.
- Security guard 24/7 is a huge benefit, and some carriers will provide a rate credit.
- For frame projects, pre-action fire suppression is usually required.

These will add to the overall project costs.

COVID-19 continues to hamper project delays. Depending on the project type and location, an extension can be problematic. Discussing potential extensions well in advance is recommended, especially for CAT-exposed projects. Many markets are applying broad exclusions in respect of direct and indirect losses arising from communicable infections.

WHEN OBTAINING BUILDERS' RISK QUOTES, INFORMATION IS KEY. **IT IS ESSENTIAL TO INCLUDE:**

- Detailed construction budget with soft cost breakdown.
- Construction timeline.
- Site plan.
- Description of any unique construction methods.
- Geotech report.
- Site security measures.
- General contractor experience and loss history.
- Description of engineered equipment, equipment with long lead times, or equipment sourced from overseas.
- For a large or more complicated project, be prepared to have multiple carriers participate in a tower.
- Specifically, outline how long quotes will be held bindable by markets.
- Determine if LEG 3 coverage is being provided on a sublimited basis.

Contractor's professional liability

THE CONTRACTOR'S PROFESSIONAL LIABILITY FOR THE FIRST PART OF 2021 REMAINS SIMILAR TO THE END OF 2020: IN A SLIGHTLY HARDENED MARKET. Capacity and competition have kept rate increases on average to single digits. For the most part, placements are still viewed on an account-by-account basis, with well-performing risks seeing minimal rate increases. Many carriers are rating contractor's professional liability risks off of past fiscal year revenues. For those companies that experienced a significant hit to their balance sheet in 2020 due to COVID-19, a challenge heading into 2021 renewals will be managing potential higher than average rate increases.

Minimum premiums in regards to excess placements should be noted for companies with a significant reduction in exposure year over year. Coverage remains robust, with carriers continuing to provide enhanced coverage terms as well as contractor's pollution and protective indemnity coverage as part of their professional liability policy. For those companies looking to place small to moderate contractor's professional liability towers, competitive capacity remains available. However, larger towers may experience some capacity concerns.

Contractor's pollution liability

As construction activities across all sectors begin to return to full operation, it is crucial that all project parties carefully evaluate environmental exposures and liabilities.

Contractor's pollution liability

Pricing for contractor's pollution liability (CPL) coverage remains highly competitive, and the coverage can provide a solution for the uptick in mold claims rippling through the industry post-completion of a project. CPL policies are most often placed on a per-project or practice basis. For renewable practice policies, rates continue to be flat to decreasing. In some cases, well-performing risks may experience rate reductions in the 5% -10% range.

Site pollution liability

Redevelopment site pollution coverage (PLL) remains readily available for landowners and can protect against unknown environmental conditions discovered during construction. This coverage aims to provide a solution to unexpected costs and delays due to unforeseen preexisting contamination. Furthermore, upon completion of the project, these policies can be broadened to include coverage for the operational phase of a property. This is particularly valuable for habitational/hospitality builds where claims associated with indoor environmental conditions (mold and legionella) are rising.

Architect & design professional liability

PROGRAM STRUCTURES AND PRICING CHARACTERISTICS OF PROFESSIONAL LIABILITY RENEWALS IN 2021 CONTINUE TO REFLECT INSURERS' EFFORTS TO REVERSE THE PROLONGED DETERIORATION OF UNDERWRITING RESULTS THROUGH RATE, RETENTIONS AND CAPACITY MANAGEMENT. Confronted with persistent heightened claims severity and long-term profitability challenges, underwriters signify "more of the same" for the foreseeable future.

Professional liability carriers generally seek rate increases of 5% - 10%; for design firms with adverse loss experience, the increases are greater and may be accompanied by demands for higher deductibles/retentions. U.S. carriers tend to offer more modest renewal increases and tolerate smaller retentions than the London and European insurers. Underwriters of excess layers remain keenly focused on rate relativity and adequacy, sometimes taking a disproportionately larger increase than underlying layers in order to right-size the pricing for their capacity. A few insurers are managing capacity through reduced lines and tighter deployment. There is ample capacity in the global A&E professional liability market for most design firms, but the pricing environment influences decisions about risk transfer, risk retention and overall limited purchasing.

While there hasn't been an industrywide adoption of communicable disease exclusions as in other lines of insurance, policy wording seems to be attracting more scrutiny in 2021. In London, this is due in part to the Lloyd's requirement that, as of Jan. 1, professional liability policy wording must be clear on silent cyber by affirming or excluding cyber coverage. As a result, underwriters are proposing overly broad exclusions as they take a conservative approach to a complex and evolving exposure. An additional consequence of the policy wording analysis is that a few underwriters are revisiting terms and conditions unrelated to cyber and questioning coverage enhancements more intently.

The professional indemnity market is still rife with coverage restrictions, reduced capacity, increasing rates and higher retentions for risks located outside of the U.S. Cladding and fire safety exposures in the U.K. and Australia continue to be subject to aggregation of limits, limit reductions through imposed sublimits, or full exclusions. The political climate and strengthening of insurance regulations in the MENA region have made it very difficult (if not impossible) to place local coverage when there is no physical business presence. In Australia, insurers are withdrawing contractual liability extensions such as those for fitness for purpose or waiver of proportionate liability.

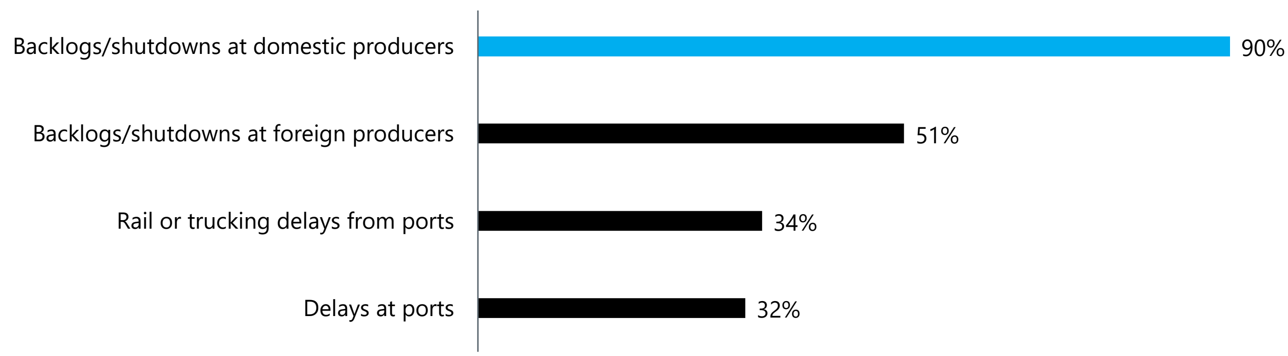
Subcontractor default insurance

Associated General Contractors (AGC) conducted a survey (Feb. 19 – March 4, 2021) of its members on the impact of COVID-19 on their operations and received 1,489 responses. The results are a cause for concern, especially as it relates to the potential for subcontractor default.

Seventy-one percent of those surveyed reported project delays or disruptions. A large percentage of these project deviations were attributable to mandated government shutdowns and owners/developers putting their projects on hold to assess the economic impact from the pandemic.

The survey identifies the following as the primary reasons for these delays.

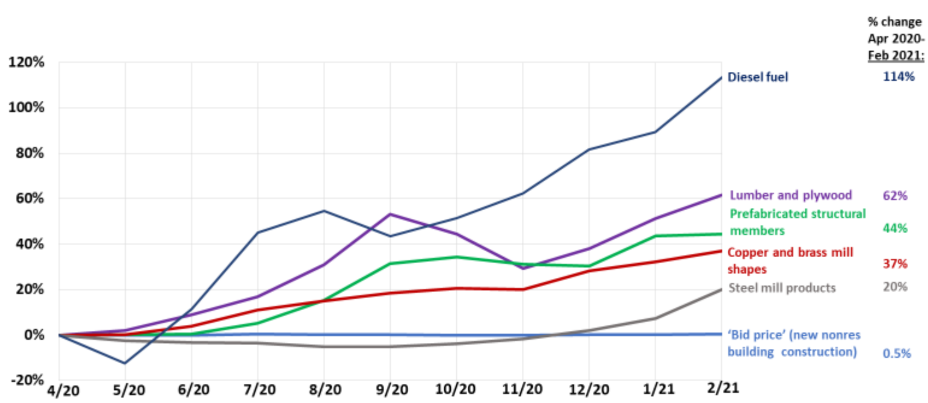
AGC SURVEY: FIRM CITE MULTIPLE REASONS FOR DELAY



Data source: AGC March 2021 coronavirus survey, conducted Feb. 19-March 4, 2021; 1,489 total respondents

PPIS FOR CONSTRUCTION & SELECTED INPUTS

CUMULATIVE CHANGE IN PPIS, (APRIL 2020-FEB. 2021; NOT SEASONALLY ADJUSTED)



At a project level, there remain concerns around available qualified workers and increasing cost of building materials. Managing increased construction costs remains a high priority for both contractors and designers.

As these issues continue to grow, the "bid price" for new non-residential building construction has had a limited increase of less than 1%. Historically the most significant risk of a subcontractor default is when the construction industry is coming out of a recession. To reduce the risk of a subcontractor default, now is the time to take your subcontractor prequalification to the next level.

Lockton recommends the following:

- More frequent reviews of subcontractor's financial statements, with close attention to available cash and lines of credit.
- Verify the workforce capacity of the subcontractor to meet the project time frames.
- Factor in the productivity impact of COVID-19 restrictions on your subcontractor's work and the project schedule.
- Ensure the subcontractor has ample time to procure any identified long-lead items.
- Select subcontractors based on both qualification and price.

The subcontractor default insurance (SDI) market remains competitive with six active carriers offering capacity. An increase in retentions is being detected from insurance markets as the average subcontractor package size increases. In addition, markets are anticipating an increase in losses, which, as noted above, has historically been the case as the construction market recovers from the recession.

Contractor surety

AS WE ENTER THE SECOND QUARTER OF 2021, IT IS HARD NOT TO REFLECT ON THE FEELINGS OF UNCERTAINTY AND ANXIETY WE ALL EXPERIENCED 12 MONTHS AGO. A roaring economy suddenly and immediately shut down. What could go wrong? With the surety industry enjoying a long stretch of excellent profitability, despite intense competition, one couldn't help but wonder if this was this the unimaginable Black Swan event that would erase a decade of profits and bring the surety industry to its knees. Would capacity evaporate, making it extremely difficult to find surety support with viable terms and conditions?

The immediate surety market reaction was most prominent in the commercial (non-construction) surety segment. Industries that were most acutely impacted by the shutdown, such as energy, retail and travel, felt the most immediate pressure from changes in terms and conditions for their surety credit. The contract (construction) segment experienced heightened underwriting attention, but generally, sureties remained supportive with no changes in terms and conditions. Most contractors entered the crisis with solid backlogs and were deemed essential businesses in most areas of the country.

While the industry is not entirely out of the woods yet, the impact of the pandemic on the surety industry has not resulted in the catastrophic event that we so anxiously feared a year ago. The federal government's intervention offered enough liquidity on very favorable terms to companies in hard-hit industries, providing an effective backstop that significantly mitigated business defaults. While premiums were flat to down slightly and there were some material surety losses experience in 2020, it will be another very profitable year for the industry and the vast majority of the surety companies. Similar results are anticipated in 2021.

Construction outlook

Contractors have done an excellent job implementing COVID-19 safety protocols and understand the cost impact of these measures.

Although some projects were canceled or delayed at the outset of COVID-19, most projects are progressing forward. In hindsight, owner decisions to close on contracts in mid-2020 likely saved them meaningful dollars, as building material and labor costs have subsequently surged.

Financial results for contractors were a “mixed bag.” Under the Cares Act, the Paycheck Protection Program buffered dismal results for some companies while boosting results for others. The impact to liquidity and equity (upon loan forgiveness) has helped contractors maintain or increase surety capacity. Backlog levels continue to be very strong in general, and the pipeline of new pursuits is robust.

Success will be more dependent on navigating and mitigating the eminent risks driven by the current market dynamics. **As noted previously, the most prominent risks include:**

ESCALATING MATERIAL PRICES

The shutdown of factories and the companies they supply products to, and increased demand and other factors have combined to change the supply and demand curve materially. In addition, freight costs are rising significantly. Locking in prices for the project’s duration, pre-purchasing/storing materials, or hedging will be vital to mitigating exposure to cost overruns.

SUPPLY CHAIN ISSUES

In addition to rising prices, the availability of materials may pose an even more severe threat to project profitability. The supply and demand issue mentioned above also impacts the lead time it takes many factories and fabricators to manufacture the materials. Further, the shortage of transit resources can dramatically extend the delivery time to the job site. Inability to get materials on time could significantly impact the schedule, resulting in delay damages, compressed schedules and extended overhead/general conditions.

SUBCONTRACTOR PERFORMANCE

Subcontractors will bear the majority of the material pricing and availability risk in addition to the labor risks. There is a very delicate balance between too much and too little work, and many subcontractors tend to gravitate toward too much work. Subs who are stretched too thin are at high risk in the current environment to either underperform or default. This will negatively impact profitability for general contractors and possibly other subcontractors on the project(s) and increase the potential for construction defects.

CHANGE ORDERS

During the past year, it has become more challenging to collect the full value of change orders. In cases of owner directives to proceed with changes to the scope of work before pricing is finalized, we have seen many write-downs in the value of the change orders that were booked by the contractor, negatively impacting profitability. There has not been an issue of entitlement, but there has been significant disagreement over valuation. As the price of construction rises, owners will likely continue to challenge the valuation of change orders.

As a result of rising construction costs, there is some underlying concern that new construction starts will slow down. However, the March Architectural Billing Index of 55 was at its highest level since 2017.
As more people are vaccinated, the economy and employment continue to rebound. Add in the high probability that a significant infrastructure bill will finally become a reality, and there is reason to be optimistic about the foreseeable future of the construction economy.

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