Replacement Cost Valuations versus Market Value

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Property owners face a growing dilemma as to how they should provide accurate replacement cost values to their insurance company when market values are declining. Logically, it doesn't make sense that the cost to rebuild your building has increased this year given the state of the economy over the past fifteen months, especially with the reduction in construction costs and decline in land values. What many owners do not consider are the fixed costs of supplies that are not decreasing.

There are several valuation trending services that can be used year after year to look at percentage increases in respects to building replacement cost values. Some insurance companies will have their own internal systems they have developed and use, where as others rely on the brokers and clients to use a reputable service like Marshall Swift and then check the increases against what they are seeing in the market. Most insurance companies require owners to review properties annually and adjust their building values accordingly.

In the past year we have received a number of comments from owners that it doesn't make sense to increase the value of their buildings this year by an inflation factor of 'x' since the building is no longer worth what we currently show as replacement cost, let alone the increased value. The first thing to remember is that an insurance underwriter is looking at the cost to rebuild the building as it stands today; they do not pay attention to the market value. When you are discussing your insurance policy renewal with your broker it may make sense to discuss how the property would be changed or re-built in the event of a loss. Sometimes rebuilding is not an option for a variety of reasons, in which case Actual Cash Value might be the better way to address the valuation. Actual Cash Value is normally defined as Replacement Cost minus depreciation.

If you drastically disagree with the replacement cost value being used, one option is to request a Replacement Cost Appraisal from an appraiser licensed in your state that is familiar with developing a replacement cost estimate. There is a fee associated with this and certainly time involved in gathering the documentation and showing the appraiser around the property. This is the most accurate way to develop that information and could be performed annually if an owner were so inclined. A more realistic scenario is to have an appraisal completed every five to ten years and then use a reliable inflation factor that is defensible to the insurance carriers.

In early 2009 the inflation factor being provided by Marshall Swift for properties in the Puget Sound region ranged between 4% and 6%. By June of 2009 the factors, which are published quarterly, had been adjusted down to somewhere between less than 1% and up to 2.5%, depending on location and construction.

We mentioned earlier that fixed costs have not changed and that is driving many of the inflation factors. As an example, the cost of scrap steel in December 2008 was $230-$235 per ton; in September 2009 the cost of scrap steel was $315 to $325.

As of October 2009, the Pacific Northwest average trending factors from various valuation sources were:

- FM Global 3.08%,
- RS Means (Negative) -2.0%, and
- Marshall & Swift (Negative) -2.25% (which represents the US average).

As you can see this is not an exact science, as the information consistently changes as market conditions change. We have heard many predictions for 2010 that trending factors for commercial buildings will range from (Negative) -5% to +5%.

The important thing to keep in mind is that during the insurance renewal cycle you will want to critically evaluate your current building replacement cost. If you are unsure how they were originally developed consider having a replacement cost appraisal completed or at least talk with your broker about reviewing your values for accuracy.