

TOP 7

MIDYEAR 2023
CONSTRUCTION INDUSTRY TRENDS



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As we reach the midpoint of 2023, a number of new trends have emerged in the industry, along with the continuation of older trends.

1 TIGHTENING CREDIT MARKETS

Since the failure of Silicon Valley Bank (SVB) on March 10, 2023, we have seen multiple projects canceled when banks have withdrawn funding. There are three large drivers for banks to withdraw this funding. First, many regional banks that provide construction financing are hoarding cash to protect against possible bank runs like the one that caused the SVB collapse.¹ Second, increased interest rates have enticed depositors to move funds from bank accounts paying almost no interest in better-paying options, thereby reducing the funds available for banks to make loans. Third, banks and others are increasingly concerned about the health of their commercial real estate (CRE) loan portfolios — particularly in the office market.

This tightening has manifested itself in increased CRE loan costs and loan-to-value ratios. In the fourth Quarter of 2022, loan costs increased 44.8% over the prior quarter.² In 2023, the average loan-to-value ratio dropped to 51%.³ Lower loan-to-value ratios force investors to invest more of their own funds into projects, which can limit the size and number of projects. Compounding the problem is that through April 2023, corporate bankruptcies reached the highest number since 2010.⁴ These corporations included anchor stores, which rented large amounts of space.

While we have seen new projects being pulled from contractors, new projects are also being downsized and delayed in the design phase.⁵ Accordingly, we can expect to see fewer projects being bid on in the coming months.

¹Gobler, Erin. "What Happened to Silicon Valley Bank?," *Investopedia*, 01 May 2023.

²Wirz, Matt. "Where is the US Economy Headed? Follow the Money," *The Wall Street Journal*, 31 May 2023.

³Id.

⁴Id.

⁵"The Top 500," *ENR*, May 1/8, 2023 at 42.



2

MARKET ROTATION

At the end of last year, Associated Builders and Contractors (ABC) was reporting a record-high backlog of 9.2 months, but this softened considerably through March when the backlog dropped to 8.7 months.⁶ This rebounded in April but it was entirely due to infrastructure spending, as backlogs in commercial, institutional and industrial markets continued to slide.

Despite the slide in overall backlogs, we are still seeing strong markets in the multifamily sector, surprising strength in retail, and only a slight softening in industrial space.⁷ The weakest demand is in office space, especially in B- and C-class buildings.⁸ As of May 22, 2023, Kastle Systems reported average office occupancy of only 49.3% among ten cities surveyed, with the highest occupancy in Houston at 61% and lowest in San Jose at 39%.⁹

As workers push back against the return to the office, employers have adopted hybrid models, reducing the amount of space they need, resulting in office tenants giving back office space and renewing leases with less space. Landlords are responding by repurposing existing space. More than 12 million square feet of office space was converted to other uses in 2022, and an additional 20 million square feet are expected to be converted in 2023.¹⁰ About a third of those conversions were to apartments.¹¹ But there are other uses. For example, as we saw an astronomical demand for medical centers and people seeking care in countless places throughout the pandemic, there is consideration and planning to convert vacant or underutilized properties to outpatient care and outpatient surgical centers to support the rapidly evolving health system.¹²

There are a number of challenges that come with re-purposing office space. For example, in concrete structures, decks will need to be core-drilled for additional plumbing and HVAC work.

This requires extensive work to identify the location of each PT tendon, and to coordinate the location of various fixtures with those tendons. These issues are unique to each building, and parties planning on such repurposing will need to consider these challenges when obtaining builder's risk and other insurance. Repurposing is not limited to office space.

Converting office to housing is gaining speed and one California assembly member has introduced a bill.¹³ The bill would:

- Prevent local governments from blocking or delaying office-to-housing projects through special permitting processes, design and planning reviews, or appeals.
- Require conversions to be allowed in all areas regardless of local zoning laws.
- Require planning departments to respond to conversion applications within 90 days of submission.
- Limit development fees on conversion projects.
- Require that all conversion projects set aside dedicate 10% of housing units for low- or middle-income residents.

Additionally, former retail locations are being converted to new uses. With most people using online facilities for their purchases, malls and shopping centers are rapidly evolving from pure shopping uses to other uses involving activities and experiences. Larger closed stores are being turned into pickleball facilities.¹⁴ Other space is being converted into simulated skydiving and golf facilities.¹⁵ Quick service restaurants (QSRs) and coffee shops are also taking over a lot of space.¹⁶

Although re-zoning is often a problem, mall department stores have been converted into multifamily residential units.¹⁷ The upshot is that contractors specializing in tenant improvements may find opportunities to re-purposing space for new uses.

⁶“Commercial, Institutional and Health Care Construction Drive ABC’s Backlog Indicator to Highest Level Since Q2 2019,” ABC, 13 December 2022.

⁷Brooks, Al. “2023 Midyear Commercial Real Estate Outlook,” J.P. Morgan Chase, 06 June 2023.

⁸Id.

⁹“Kastle Back to Work Barometer,” Kastle, 12 June 2023.

¹⁰Shaver, Leslie. “Office Conversions will Soar this Year,” MultiFamily Dive, 30 Jan 2023.

¹¹Id.

¹²Carter, Amy and Susan Sakiyabu. “5 Strategies for Converting Retail and Office Space into Ambulatory Surgery Centers,” Gensler, 07 June 2022.

¹³Varian, Ethan. “New bill aims to convert California’s office into housing,” Wittier Daily News, 06 March 2023.

¹⁴Meyersohn, Nathaniel. “America’s fastest growing sport is coming to your mall,” CNN Business, 15 May 2023.

¹⁵Id.

¹⁶“Discount and fast food are bright spots as retail absorption slows,” JLL, Q1 2023. PDF download.



3

CONTINUED CONSTRUCTION LABOR AND ENGINEERING TALENT SHORTAGES

We are continuing to see a labor shortage impacting project delivery. In fact, ABC predicts that 546,000 new workers are needed to fill construction demand in 2023.¹⁸

One sub-sector of the labor shortage involves historic trade work. More than 40% of all US buildings were constructed more than 50 years ago, and renovation of such buildings may qualify as historic preservation.¹⁹ This, however, requires craft workers trained in historic building techniques. Historic restoration work generates 165,000 jobs each year and it is estimated that the industry needs to add 10,000 workers per year with historic trades training.²⁰

The labor shortage is not limited to construction workers, and the American Council of Engineering Companies is lobbying Congress to expand H-1B Visas to allow international students obtaining advanced engineering degrees in the US to stay here to help fill that demand.²¹ Indeed, lack of design talent is a significant constraint on green building and is causing some design firms to be more restrictive in what green projects they are taking on.²²

No other construction industry is facing a more pronounced gap in available workers than infrastructure.²³ According to Forbes, over 40% of the current US construction workforce is expected to retire over the next decade. To compete with other industries, the construction industry continues to evolve to appeal to a younger and more tech-savvy generation by engaging in advanced digital technology. In addition to technology, the next generation of workers is looking for well-being benefits and makes this one of the key criteria when applying for new jobs.²⁴

We see this labor shortage driving many other industry trends as companies look for ways to replace labor. This includes increased use of robotics to perform repetitive tasks, such as bricklaying, painting, and rebar installation and tying. We also expect to see more modular and prefab construction, and faster growth in 3D-printed concrete.

¹⁸["ABC Workforce Development," ABC](#), accessed 12 June 2023.

¹⁹"Preserving Historic Restoration," *ENR*, May 15/22, 2023 at 53.

²⁰Id.

²¹"ACEC Calls for Changes in H-1B Visa Program," *ENR*, May 12-20 2023 at 8.

²²"The Top 500," *ENR*, May 1/8 2023 at 52.

²³Katara, Si. "[Replenishing the Construction Labor Shortfall](#)," *Forbes*, 18 Aug 2022.

²⁴Meister, Jeanne. "[The Future of Work: Offering Employee Well-Being Benefits Can Stem the Great Resignation](#)," *Forbes*, 16 Dec 2021.

4

CONSENT AGREEMENTS

With banks tightening their lending standards, parties contracting with the owners need to be more attentive to consent agreements. Lenders usually require the project owner to obtain consent agreements from designers and contractors, pursuant to which the designer and contractor consent to an assignment of their contracts with the owner to the lender in the case of foreclosure. These agreements are often presented after the contract has been finalized, and the designer or contractor has already started work.

These agreements often contain terms modifying the underlying design and construction contracts if the lender takes over. These modifications can include items like:

- Transfer of ownership of plans and specifications to the owner.
- Release of any claims against the lender for amounts not paid by the owner prior to the assignment.
- Agreements making the lender a third-party beneficiary to the underlying contract. This allows the lender to file a suit against you for alleged breaches of the underlying design or construction agreement.
- Waivers of certain contract rights and the right to lien the project.

Because these agreements can significantly affect the contract rights, designers and contractors should include language in their contract agreeing to sign consents only if there are no material modifications to the underlying agreement. They must also review consent agreements carefully before signing.



5

ARTIFICIAL INTELLIGENCE (AI)

In November 2022, Open AI released ChatGPT for testing to the general public.²⁵ Earlier AI models could identify patterns, and make classifications and decisions based on those patterns, but ChatGPT and other “Generative AI” can develop new content.²⁶ For example, earlier versions of AI could look at pictures of different animals and distinguish a dog from a horse but could not create a picture of either animal. Generative AI can now generate a picture of an imaginary horse based on the common characteristics it identified in pictures of real horses.

Generative AI is trained through a review of existing data. Indeed the “P” in ChatGPT stands for “Pre-trained,” and ChatGPT was trained to recognize word patterns from a large amount of text so that it could predict what the next word in a sequence might be.²⁷ Generative AI will accordingly be useful in design and construction only to the extent the program has access to sufficient data. With this data, however, both traditional machine learning and Generative AI can radically change the construction industry — much in the way that Building Information Modeling (BIM) (a form of AI) replaced blueprints with 3D models.

Water provides one of the most promising areas of design and construction AI applications. Plumbing failures cause about 50% of all builder’s risk claims, but smart water systems can catch leaks quickly, reducing the loss.²⁸ One user reported a 10% reduction in builder’s risk insurance premiums from using such systems.²⁹ Once these systems are installed, they can also reduce water damage in completed buildings and be used to monitor water usage to detect waste.

In architecture, Generative AI can use algorithms to create and then test hundreds or thousands of alternative designs against metrics identified by the architect.³⁰ One potential benefit of AI design is that it can reduce risks by identifying incompatible materials or systems.³¹ Because current AI is used to measure designs against specified metrics, it currently can also be used to help design for energy efficiency, greater accessibility and safety and better traffic flow.³²

Since Generative AI is based on patterns, it should soon be able to generate new designs based on existing models. For example, using a database of Frank Lloyd Wright designs, architects could use Generative AI to design a house in the style of Frank Lloyd Wright for a specific site.

While humans will still be needed to direct what is generated, establish parameters and metrics, and vet the resulting product, Generative AI holds the promise of releasing humans from the need to perform much of the “grunt work” used to generate actual designs. We expect to see rapid adoption of Generative AI in the design space to counter the shortage of design talent described above.

²⁵[“What is generative AI?” McKinsey & Company](#), 19 Jan 2023.

²⁶Id.

²⁷Wilson, Mark. [“ChatGPT explained: everything you need to know about the AI chatbot.” TechRadar](#), 15 March 2023.

²⁸“Water Tech Getting Smarter,” *ENR*, May 15/22 2023 at 43

²⁹Id.

³⁰Ahmad, Rafay. [“Generative Design, AI & Architecture.” Green Arch World](#), 18 Sept 2022.

³¹Haworth, Russell. [“Generative AI In The Construction Sector: Taking Building Technology To New Heights.” Forbes](#), 2 May 2023.

³²[“The Future of Design: Exploring Generative AI Applications in Architecture and Urban Planning.” iffort](#), accessed 12 June 2023.

6

NET ZERO STANDARDS

Many private developers insist on Leadership in Energy and Environmental Design (LEED) certification because it has become a commonly accepted certification of “greenness,” so that LEED-certified projects tend to command higher sales prices.³³ Many clients are also seeking net zero projects, where the project produces as much energy from green sources as it consumes, but there has been no widespread, commonly accepted certification for net zero, similar to the LEED certification.

That may be changing as the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE) has recently published the ANSI/ASHRAE Standard 228-2023, Standard Method of Evaluating Zero Net Energy and Zero Net Carbon Building Performance.³⁴ This standard is currently on continuous maintenance, and will likely evolve as users apply it — much in the way that the US Green Building Council (USGBC) modified LEED standards early in the process to identify better approaches. Soon, however, we could see net zero certification based on a matured version of the standard.

Net zero facilities generally use on-site energy sources, like solar panels and geothermal wells to balance out the energy received from external sources. One significant development in the ASHRAE process is that it addresses sites that cannot produce sufficient renewable energy by evaluating external energy sources, including energy used in the extraction and lost in transit to the site.³⁵ Accordingly, it is possible that the developer of a new project on a small site will be able to achieve net zero certification by using solar panels on adjacent or nearby sites.

While contractors are familiar with using adjacent sites for staging, construction across both the owner’s site and adjacent sites for installation of such panels will create new risks that will need to be addressed.

Another factor impacting green construction is the Inflation Reduction Act of 2022, which included \$369 billion in spending for America’s energy system and similar investments through the 2021 Infrastructure Law.³⁶ Much of this money is devoted to reducing greenhouse gas pollution in power generation, industrial processes, buildings and transportation. This is already having an impact as the increased backlog identified by ABC in April 2023 is entirely due to infrastructure spending.

Because of the highly nuanced nature of this market, it is imperative that you are working with an insurance broker who specializes in your particular industry or line of coverage. Due to the variability that we’re seeing in this market and specific account characteristics, your individual situation may vary from others. Gallagher has a vast network of construction specialists who understand your industry and business, along with the best solutions in the marketplace for your specific challenges.

³³[“ESG in Construction,”](#) *Engineering News-Record*, 3 Feb 2023.

³⁴[“ASHRAE Publishes First Zero Net Energy and Zero Net Carbon Standard,”](#) *ASHRAE*, accessed 12 June 2023.

³⁵*Id.*

³⁶ [“The Inflation Reduction Act Drives Significant Emissions Reductions and Positions America to Reach Our Climate Goals,”](#) *US Department of Energy*, Aug 2022. PDF download.





7 INCREASE IN THE PRICE OF LUMBER

With the wildfire season coming, we're already seeing lumber prices rise in Canada. Canada is the world's second-largest softwood lumber producer, and the above-average number of fires have destroyed at least 9.9 million acres. Sawmills and harvesting activities have temporarily closed, and workers have been laid off until it's safe to resume production.³⁷ This decrease in operations is causing prices to increase.

Much like Canada, the price of lumber in the US is also rising. This price increase is mainly due to the fact that lumber has become less available due to taxes and natural disasters. There is also a housing shortage currently going on in the US, so there is a constant need for lumber and additional wood products.³⁸ With there being a low supply and high demand for lumber in the US, this will be a tough season in the future.

With there being a low supply and high demand for lumber in the US, this will be a tough season in the future. Be sure to prepare by adding Escalation Clauses in your contracts. **Contact your Gallagher representative** for more information on three escalation clause suggestions that have been drafted for prime contracts with the project owners or developers.

Contractors can either include the appropriate clause directly into the prime contract itself, or incorporate it into the guaranteed maximum price (GMP) or lump sum price amendment later (assuming price is not set at the time the prime contract is signed).

The escalation clauses are generally the same with a few key differences:

1. The first escalation clause is tied to only certain specific items,
2. The second applies to all materials and equipment,
3. The third while is a global clause that would apply to all items, including materials, equipment, services and labor.

Please note: Before inserting any of these clauses into a contract, the language of that clause may need to be adjusted to reflect the terminology used in the subject prime contract.

³⁷Meredith-Miller, Brittney. "[Canadian wildfires affect air quality, lumber production](#)," *Property Casualty 360*, 13 June 2023.

³⁸Chesney, Carey. "[Why is Lumber So Expensive in 2023?](#)" *Rocket Homes*, 31 May 2023.

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