

The Importance of Insurance to Value for Commercial Property Coverage

When purchasing or renewing their commercial property insurance, it's vital for businesses to ensure such coverage includes correct property valuations. Doing so can make all the difference in providing sufficient protection and preventing coinsurance penalties amid covered property losses. That's where conducting accurate insurance-to-value (ITV) calculations comes into play. Generally speaking, ITV refers to an approximation of the full cost to replace or restore insured property.

Businesses may end up with inaccurate ITV calculations for a wide range of reasons—whether it stems from leveraging ineffective property valuation methods, intentionally underestimating costs in efforts to secure reduced premiums or being impacted by factors outside of their control (e.g., inflation). Regardless, such inaccuracies are all too common. In fact, an estimated 75% of commercial properties are underinsured by 40% or more, according to industry data.

With these findings in mind, it's evident that businesses need to take commercial property valuations seriously. This article offers more details on ITV, outlines factors to consider when determining a property's value, explains the pitfalls of property undervaluation and provides best practices for improving property valuation measures.

ITV Explained

An accurate ITV calculation represents as close to an equal ratio as possible between the amount of insurance a business obtains and the estimated value of its commercial property—thus ensuring adequate protection following property losses.

However, it's important to keep in mind that a property may be assigned several different values, including the following:

- **Market value**—This value is an estimate of what a property could be sold for in the present real estate market. The market value of a property is based on elements such as lot size, building condition and location desirability.
- **Assessed value**—This value is an estimate generated by the municipality where a property is located. Such a value is typically utilized to determine local property taxes.
- **Replacement value**—This value is an estimate of the current cost to replace or rebuild a property. The replacement value of a property depends on characteristics such as material and labor expenses, architect services, debris removal needs and building permit requirements.

Generally, insurance experts recommend using the replacement value of a property to conduct correct ITV calculations. Common approaches to accurately estimating this value include getting a property appraisal from a third-party firm, leveraging fixed-asset records that have been adjusted for inflation or relying on a basic benchmarking tool (e.g., dollars per square foot).

While appraisals often require more time and resources than other property valuation methods, they are largely deemed the most thorough and accurate.

Factors Impacting Property Value

Apart from utilizing replacement value estimates within ITV calculations, businesses should consider the following factors to determine correct property valuations:

- **Direct and indirect expenses**—In addition to direct costs, such as material and labor expenses, property valuations should incorporate indirect costs, such as consulting fees, engineering services and other expenses not directly associated with rebuilding.
- **Property age**—In the case of older structures, property valuations should include additional construction costs that may arise from upgrading outdated building materials and equipment.
- **Building codes**—Older properties may also require certain modifications amid the rebuilding process to comply with modern building codes (e.g., plumbing improvements, energy efficiency upgrades, sprinkler system changes and safety enhancements). These adjustments may further compound construction costs, driving up property valuations.
- **Property accessibility**—Properties situated at steep locations or adjacent to neighboring structures may need to have bracing or other safety measures put in place during demolition and rebuilding operations to ensure accessibility. These measures should also be factored into property valuations.
- **Unique features**—Some custom property elements (e.g., stained glass) could necessitate specialized construction work, elevating rebuilding costs. Therefore, it's crucial for these unique features to be incorporated into property valuations.

Consequences of Property Undervaluation

Businesses could face a number of ramifications if they conduct inaccurate ITV calculations and undervalue their properties. Namely, businesses may lack sufficient coverage following property losses, forcing them to pay out-of-pocket expenses in order to fully rebuild. Depending on the severity of property losses and associated rebuilding operations, paying these costs out of pocket could lead to major financial setbacks and—in certain scenarios—bankruptcy.

Additionally, property undervaluation can sometimes result in coinsurance penalties. Most commercial property insurance policies include coinsurance clauses, which encourage policyholders to carry reasonable and accurate amounts of coverage. Under a coinsurance clause, a policyholder is subject to a penalty—generally, a reduced payout—if their coverage limit is not at least equal to a predetermined percentage (e.g., 80%) of the value of their property.

A coinsurance penalty limits the amount recoverable following a loss. To calculate the amount recoverable for a policyholder who doesn't meet their coinsurance clause requirements, the amount of insurance carried should be divided by the amount of insurance required, then multiplied by the loss cost. For example, if an insured's property is valued at \$1 million, but their coverage limit is \$700,000 and their policy includes an 80% coinsurance clause, they would likely only receive a \$43,750 payout after incurring \$50,000 in property damage from a covered event, depending on when their deductible is applied ($(700,000/800,000) \times 50,000 = 43,750$).

Ways to Improve Property Valuations

Here are some additional best practices businesses can review to help ensure accurate ITV calculations and improve their property valuation measures:

- **Find a reputable appraiser.** Third-party appraisals are considered the gold standard in property valuations by insurers,

as they offer reassurance that calculations were conducted by experienced and objective professionals. As such, it's vital to secure a trusted and reputable appraiser. Be sure to find a firm that follows the Uniform Standards of Professional Appraisal Practice and the Code of Professional Ethics and Standards of Professional Practice from the Appraisal Institute.

- **Seek additional resources.** In addition to getting an appraisal, there are additional industry resources, reference guides and validated tools available to help ensure accurate property valuations. Specifically, the Marshall & Swift Valuation Service Cost Manual is a tool that is widely accepted by insurers. This resource features more than 30,000 component costs across 300 building occupancies that can be referenced when conducting valuations.
- **Consult other parties.** Determining the value of a property should be a team effort. Make sure to compile a variety of property data from multiple qualified parties (e.g., accountants, contractors, real estate experts, risk managers, insurance professionals and chief financial officers) when making valuation decisions.

- **Make updates as needed.** The value of a property is always changing. This means it's imperative to update property valuations on a regular basis. For instance, appraisals should be conducted at least every three to five years. Take note that property valuations may need to occur even more often. The frequency will depend on factors such as changing property exposures, altered operations, building upgrades or modifications, the implementation of new technology or equipment on-site, shifting market conditions and property construction trends (e.g., inflated labor and material costs). It's best to work closely with trusted insurance professionals when updating property valuations to maintain ample coverage and prevent coinsurance penalties.

Conclusion

Ultimately, it's clear that correct property valuations are critical in securing adequate commercial property insurance. By better understanding how to conduct accurate ITV calculations, businesses can stay protected when covered events occur and avoid potential coinsurance penalties. Contact us today for additional insurance guidance and solutions.

Ames & Gough, as your insurance and risk management advisor, is providing this update to assist you in your risk management efforts. While insurance is a critical component of any risk management and risk financing plan, the most important thing your organization can do is to work to prevent or minimize losses before they occur. If you have any questions or need further information about this topic and related issues, please contact your Ames & Gough client executive.

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