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Dimensions
A CPA's Report for the Construction Industry Fall 2021

Insurance Costs

Rising Premiums Pose Challenges to Contractors

With the economy showing signs of inflationary pressure, controlling costs is an increasingly important priority for many construction businesses. As if wildly fluctuating building material prices weren't challenging enough, a growing number of contractors are encountering another area of cost concern: rapidly rising insurance premiums.

The Current State: Premiums Increase Across Many Lines

Although the COVID-19 pandemic is one factor driving up insurance premiums, it is far from the only cause. General uncertainty about the economy, rising reinsurance costs, and declining underwriting profits are also putting pressure on insurance carriers, leading to a broad-based rise in premiums across various types of coverage.

One leading national brokerage company projects that general liability rates will increase by 5 to 15 percent in 2021, with auto liability rates increasing by as much as 20 percent. Premiums for builder's risk insurance, which pays for damage done to a structure still under construction, are expected to increase by 10 to 15 percent this year, as are premiums for commercial property insurance. One possible bright spot is workers' compensation insurance, where rates appear to be relatively stable for now.

In addition to raising premiums, some insurers are growing reluctant to place large umbrella policies with high limits. In such situations, contractors must either accept lower coverage limits and increase their own risk exposure or purchase a separate excess liability policy for losses that exceed their general liability limits. Unsurprisingly, even more dramatic increases are expected in the excess liability market, with premiums projected to increase by as much as 100 percent for some businesses this year.

Strategies for Controlling Insurance Costs

The first step to hold down insurance costs is an in-depth discussion with your company's insurance agent. In today's environment, it is good business to build ongoing relationships with agents and underwriters rather than to wait until policy renewal time to get in touch.

This discussion should be incorporated as part of a broader review of your company's overall risk management program and philosophy. A comprehensive risk assessment will enable management to make reasoned and deliberate decisions regarding how much risk the company can afford to bear on its own while still complying with any minimum coverage requirements that lenders and bonding companies may impose. Such an assessment can also help management decide whether some alternative strategy, such as forming or joining a captive insurance company, could be a viable option. (See "Should You Form a Captive Insurance Company?" on page 3 of this issue.)

Rising premiums can also affect other aspects of business strategy. For example, insurance costs should be factored into bids. They could even affect whether to engage in certain types of work at all. This is particularly important if a company starts pursuing projects that are substantially larger in size or scope than it traditionally handles.

Some project owners, especially large national clients, may also require contractors and subcontractors to maintain specific umbrella

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Transition Planning

Build Value Into Your Company

When a company faces a change in ownership—whether it's through a sale, merger, or other type of transition—an accurate business valuation is an essential early step. However, construction businesses can be especially difficult to value.

Because a good portion of a company's value depends on its income-generating capabilities, most valuations involve some subjective analysis regarding future business and economic trends. In addition, many construction-related businesses rely heavily on the owner or a few key employees. A prospective buyer will naturally discount the value to reflect the loss of continuity.

Despite uncertainties, there are some proactive steps that construction company owners can take to increase the value of their businesses in anticipation of a sale. What's more, even contractors who do not anticipate an imminent change in ownership can benefit from some basic value-building actions as a strong balance sheet can also help boost credit and bonding capacities.

Variables That Drive Valuation

One place to start when determining the value of a business for sale is to review recent sales or mergers involving comparable companies and similar circumstances. Such market-based valuations can provide a reference point, but because no two transactions are identical, an appraiser must make several adjustments and allowances.

Like the analysis of future business trends mentioned previously, these adjustments require some subjective analysis by the appraiser. In addition, when the comparable transactions involve privately held businesses, much of the relevant information may not be publicly available.

Regardless of whether the appraiser is adjusting the valuation to a comparable transaction or starting from scratch, the final valuation will consider a

number of factors, which can be grouped into three broad categories:

- **Assets.** This includes real property, equipment, other tangible property, notes, accounts receivable, and various intangible assets such as a strong management team, a productive workforce, and a strong and loyal customer base. An equipment appraisal is usually a major component of a construction business valuation.
- **Income.** Estimates of future income will also depend on some intangible factors, particularly the management team and the company's customer retention record. From a technical standpoint, appraisers often use either the discounted cash flow method or the capitalization of earnings method and then make adjustments to normalize expected earnings.
- **Risks.** Litigation risk and potential labor issues are obvious risk factors to consider, but other, less apparent types of risk affect value as well. For example, a company whose revenues come from a single client, or whose work is concentrated in only one type of project or one sector of the economy, is inherently less valuable than one with a more diversified portfolio.

Steps That Can Build Value

Those same three categories—assets, income, and risk—can provide a framework for building a construction business's value in advance of a sale or other transition. If you are preparing your company for such an event, here are some practical steps you can take to increase the value of assets, improve income prospects, and lower risk:

- **Build a strong team.** A strong management team makes any business more attractive to a prospective buyer. What's more, a group of experienced managers could themselves be good prospects for the sale.
- **Clean up operations.** Strip out non-operating assets and extraneous operations or spin-offs. It often is best to carve out real estate assets or other entities that can be easily separated from the main contracting business.
- **Build the backlog.** But do not let quality suffer in the pursuit of volume. Instead, find your high success areas and focus there. Analyze job histories to determine which projects produced the highest margins, while also studying the market to determine the best prospects for continued growth.
- **Keep assets in good repair.** Stay current on scheduled maintenance for vehicles and other equipment, and replace aging equipment as necessary. A healthy backlog is less valuable if the new owner will need to replace old, worn-out equipment to perform the work.
- **Get the business in order.** Dispose of unneeded equipment, and trim back owners' perks such as cars and personal expenses to be sure the company is running as lean as possible.

Finally, make sure the current corporate structure is conducive to a sale and that documents include clear provisions for a smooth transition or dissolution of the business.

Call us today for more information on business valuation or other transition issues.

Weighing the Pros and Cons

Should You Form a Captive Insurance Company?

With insurance premiums rising rapidly, many contractors are looking to form a captive insurance company or join an existing captive group or association. Although the initial financial and legal requirements are considerable, a captive insurance company can offer advantages, particularly for larger companies with sizable annual premiums across various lines of insurance.

Understanding the Basics

A captive insurance company is a legally licensed, limited-purpose property and casualty insurance company formed specifically to insure the risks of its owners. Owning a captive gives the parent company more direct control over its insurance so it can tailor coverage to meet its particular needs. As a legitimate insurance company, a captive also can directly access major reinsurance providers who underwrite the captive's risk, thus avoiding a commercial carrier's commission.

Contractors can form captives to provide coverage against various risks including general and umbrella liability, auto insurance, employee benefits, and workers' compensation, among many others. Some contractors use a captive to cover risks their commercial policies exclude or to add coverage beyond their policies' maximum limits. Another approach is to purchase high-deductible, lower-cost coverage from a commercial carrier and then use the captive to provide "first dollar" coverage for losses less than the deductible.

Addressing the Complications

Unlike simple self-insurance, a captive is managed, operated, and regulated as a legitimate insurance company. This means it must meet the minimum capitalization and reserve requirements of the jurisdiction in which it is domiciled, and it must spread its risk exposure adequately across various risk categories.

Although very large companies may be able to meet these requirements and form a pure or "single-parent" captive, many midsize contractors find it more practical to be part of an association or group captive, in which multiple companies pool their resources to share risks. Even then, forming or joining a group captive requires a sizable upfront commitment of both time and financial resources, in addition to premiums paid.

A captive insurance company should be regarded as a long-term risk management strategy, not just a cost-saving measure. And while a captive can also offer tax advantages in certain cases, the decision to form a captive should never be made on the basis of tax considerations alone.

Under the right circumstances, a captive insurance company could be a viable strategy for companies that must pay hundreds of thousands of dollars in premiums annually. But the many complexities mean that advice from an experienced insurance agent or broker is essential, along with counsel from your financial, tax, and legal professionals.

If you would like to discuss this or any other risk management issue, please call us for an appointment.

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liability limits. Contractors should be alert to such requirements and be ready to reconsider such opportunities if insurance costs would reduce the potential return to be below acceptable levels.

In addition to such strategic considerations, do not overlook more basic, tactical steps that can also reduce premiums. For example, review the appraised values for equipment listed on insurance policies to determine whether they reflect the purchase price or the replacement cost for comparably used equipment. A review of local equipment auction prices can help you develop a more realistic depreciated value, which could help lower the premiums for contractor tool and equipment insurance.

This is not to say that insuring equipment for full purchase price is wrong—in fact, it could be a wise choice. But the choice should be made deliberately after carefully balancing the costs against the potential risks.

Finally, do not overlook the most important tool for holding down insurance costs: running a solid, safe operation. A strong, proactive safety program with thoroughly documented results not only helps hold down insurance premiums, it also produces a host of other essential benefits.

Although rising insurance costs can create financial pressure in the near term, prudent contractors can still find ways to navigate the uncertainty and manage the risks successfully.

Please call us if you would like to schedule a review of your risk management strategies.

We use our expertise to help our clients grow and prosper.

Dermody, Burke & Brown, CPAs, LLC

Our mission is to empower our clients and our people to "live well" by providing valued advice and innovative solutions in an atmosphere that is professional, enjoyable and community minded.

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Construction Technology

Five Tech Trends to Watch

Keeping up with ever-changing technology can seem like an overwhelming challenge. Deciding which tools make sense for your company can be complicated.

An important first step is simply understanding which types of technology are impacting the construction industry today and which are likely to see continuing advances in the near future. Here are five broad technology trends that industry observers are watching.

1. **Mobile technology and remote data access.** Cloud data storage now makes it possible for managers to remotely access all types of data including project files from virtually anywhere. It also makes cybersecurity an even more critical concern.
2. **Digital data and automation.** Not only is data digitization an obvious prerequisite for remote access, it is also a requirement for most other technological advances including robotic process automation for financial and administrative tasks. Fortunately, optical character recognition technology that converts paper files into digital data is now readily available.
3. **Building information modeling (BIM).** Although architects have used BIM technology for more than 20 years, its widespread use in construction is a more recent trend. BIM collaboration software helps project teams coordinate their functions and work together more efficiently while also providing long-term value to project owners.
4. **Jobsite technology.** Drones, geofencing, and other satellite-connected tools are becoming increasingly common on work sites, enabling improvements in both efficiency and worker safety.
5. **Artificial intelligence and machine learning.** The next few years are likely to see dramatic advances in the use of these futuristic technologies across all aspects of the business including project planning and scheduling, estimating, operations, and even lead generation and overall business strategy.

Please call us if you would like to discuss how technology could impact your business.