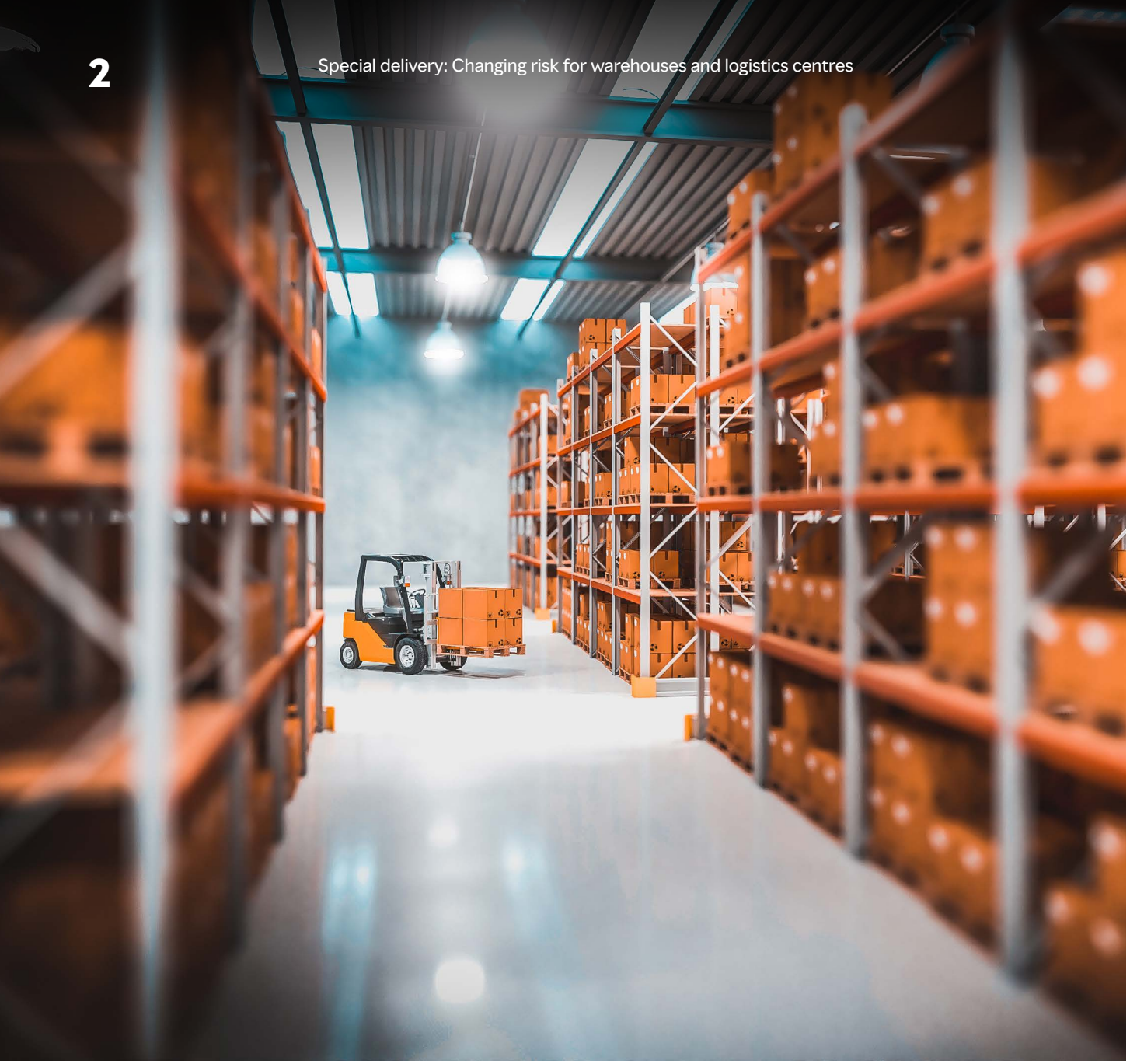
Marsh

Marsh Specialty

Special delivery: Changing risk for warehouses and logistics centres

A guide to construction insurance for owners and developers.

July 2022



GROWTH OF UK LOGISTICS CENTRES AND WAREHOUSING

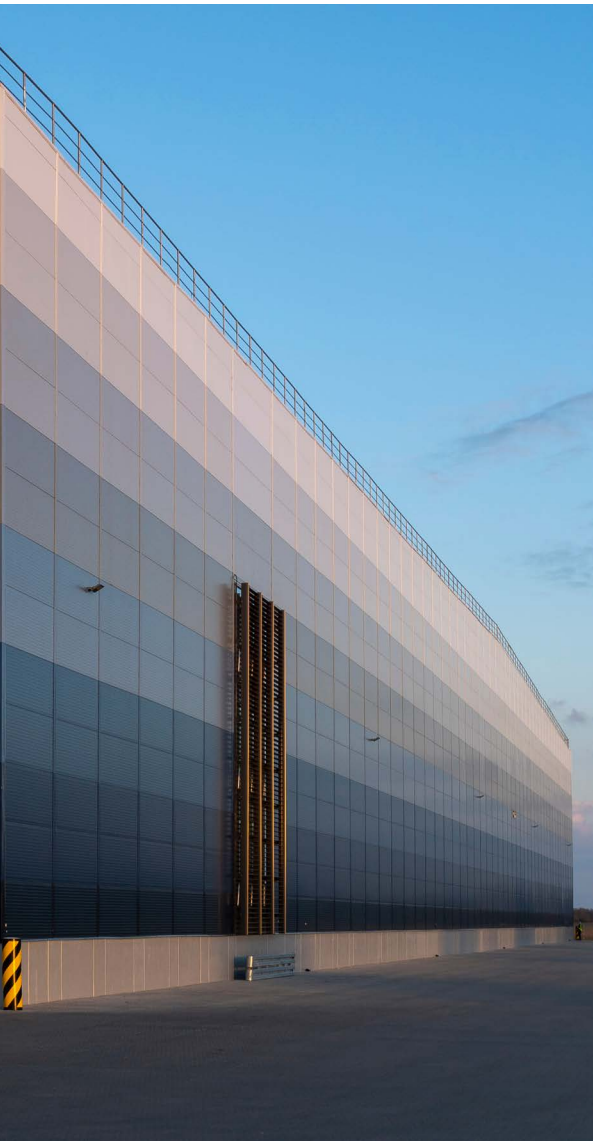
Huge, shed-like buildings are appearing all over the UK, in urban, suburban, and rural locations alike.

These logistics centres are the new big thing in property development countrywide, given the meteoric rise of online shopping in recent years. Between 2015 and 2021, the UK warehousing footprint for online retailers grew from 8 million square feet to 60 million square feet. This amounts to a rise of 614% over six years. In the three months leading to the end of January 2022, warehousing projects worth £341 million commenced, a growth of 37% compared to the same period in the previous year.[1]

Warehousing and logistics is expected to remain a growth area due to post Brexit stockpiling, and the increase in online retailing accelerated by the COVID-19 pandemic. Online retail is expected to contribute up to 35% of the retail sector by 2025. Based on this, it is forecast that 64 million square feet of additional warehousing space will be required.

Increasingly, online retailers are regarding themselves as logistics companies, with a focus on delivering products to customers as quickly as possible. They are not just looking to build mega distribution warehouses, but also smaller storage hubs that enable service efficiency and speed up their ability to transport products ‘the last mile’ to the consumer.

What are the risk and insurance considerations for owners and developers wishing to enter this sector? The full landscape of risks should be discussed with a construction insurance broker, however the following could be taken into consideration.



LOGISTICS CENTRE AND WAREHOUSE CONSTRUCTION-RELATED RISKS FOR OWNERS AND DEVELOPERS

In order to gain a full understanding of the insurances associated with the building of logistics centres and warehouses, owners and developers should make themselves aware of the construction risks related to this type of project.

Pre-construction risks

Logistics buildings share many of the construction risks that are typical for the industry, such as materials shortages and a labour shortfall. Some risks specific to a logistics centre arise before the building itself commences.

The land purchased on which to build the facility might not be of optimum quality, so remedial groundworks might need to be undertaken before construction starts, in order to increase and maintain its stability. Before the plot is sold to the developer, the ground is prepared and transport interfaces are built. Groundworks may include installing drainage systems, laying water/gas pipes and electricity cables, and creating rail and road access.

Excavation works for drainage systems, pipework, and cables are associated with risks such as trench collapse and the chance of people and vehicles falling into the excavation, while third-party risks arise with the creation of rail spurs or access roads connecting with live roads or railways.

When a centre is near a residential area, planning consent may be withheld unless a form of screening/soundproofing is included in the scheme.

Construction risks

The biggest risks for developers arise during the fit-out phase, with the installation of machinery, such as conveyor belts and robotics. On a conventional build, the client completes the project, with insurance cover transferring over to the property policy. However, in the case of logistics centres, cover should be maintained under the construction policy during fit out, testing, and commissioning, due to the incidence of early occupation — tenants may want to fit out areas of the warehouse while the contractor is still building it. These projects can also have more requirements for testing and commissioning than normal, for example, hot testing.

In this instance, the contractor may be insured for the works on the logistics centre, but not for the works undertaken by the fit-out contractors. It is this potential for disparity that makes the owner-controlled insurance programme (OCIP) route more appealing for developers, as it ensures that all works are covered. See below for more information about OCIPs.

While a warehouse itself is a relatively straightforward build, developers need an understanding of what cover to put in place for the fit-out to ensure it is adequate for the client's needs. There needs to be an understanding of the equipment — especially if it is prototypical — and consideration must also be given to the insurer's understanding of the nature of the equipment.

Delay in start-up (DSU) cover as a driver for OCIP solutions

A long delay in completion could have a negative effect on income. Therefore, for an owner, DSU cover is often a key driver in purchasing the construction insurance for example, through an OCIP.

In its simplest form, an OCIP is an arrangement whereby the client takes control and purchases bespoke, all-party cover for the project. The OCIP approach enables the owner or developer to do the following:

- Arrange DSU insurance to provide an indemnity for lost revenue arising from a delay caused by insurable damage.
- Obtain finance for the project on a non-recourse basis; it is unlikely that lenders' insurance requirements (including DSU) could otherwise be met.

If DSU or non-recourse finance are required for any project, these factors would usually necessitate an OCIP approach, because the contractor cannot arrange this type of insurance cover, and it is not available as a stand-alone policy.

Fire Precautions

Consideration also needs to be given to the insulation materials used within the building, both as part of any external cladding system, as well as within any internally insulated areas — cold stores for example. Both external and internal insulation materials often contain foam products, which can be highly combustible. The presence of large amounts of combustible insulation materials — either in the building structure or internally within any cold storage areas — provide a significant challenge to fire fighters, often restricting intervention to external firefighting, which may result in a total loss of the building.

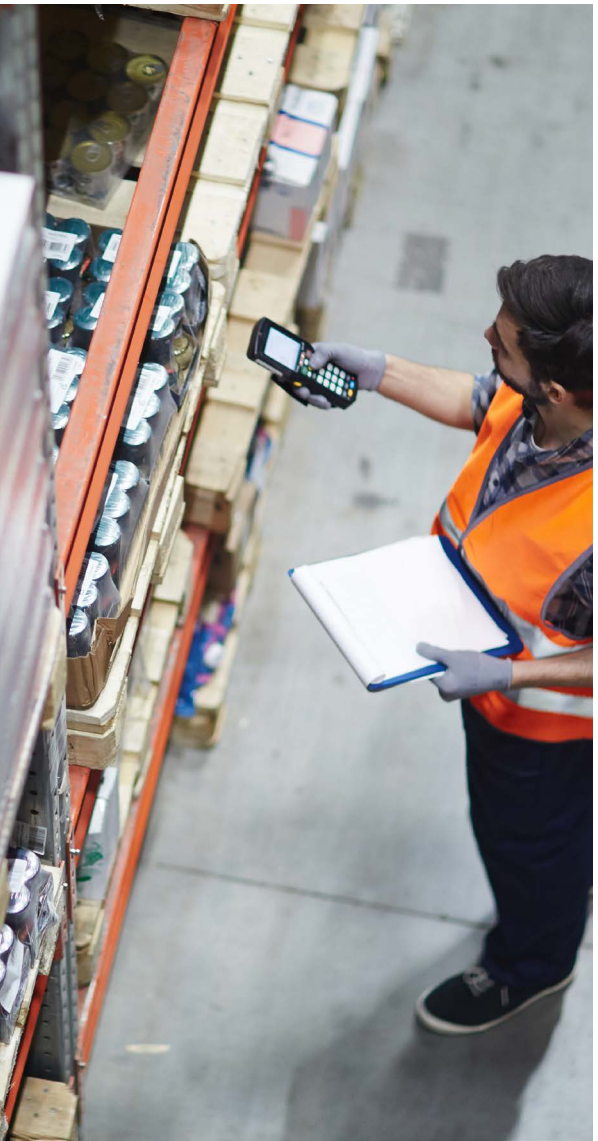
These materials significantly increase the fire load of the building and form part of insurers' underwriting considerations. Insurers would prefer to see non-combustible insulation materials used in the construction of the building (such as mineral fibre or rock wool). However, where the use of foam products is unavoidable, as is the case with cold storage facilities, materials should be Loss Prevention Certification Board (LPCB) approved in order to satisfy property insurers. Maintenance of a good standard of fire safety management will also be a key consideration for insurers when underwriting the risk.

ADDITIONAL COVER FOR OWNERS AND DEVELOPERS: LATENT DEFECTS INSURANCE (LDI)

Defects in warehouses are mainly associated with ground movement and/or inadequate foundation design or construction, which manifests in the form of cracking, distorted frames, shrinkage, and heave of adjacent external ground levels.

Developers should consider LDI, which is excluded under the property policy. If a defect in a building is discovered, making a claim against professional indemnity (PI) insurance can be difficult and time-consuming. Owners and developers often purchase LDI cover as an alternative.

LDI is a 10- or 12-year policy that incepts after practical completion of the works and provides cover for any structural defect discovered in the building. It is also a first-party policy that attaches to the building and is fully transferable if the building is sold. It can be extended to cover mechanical and electrical items, and loss of rent.



Post construction

A warehouse has a large expanse of concrete flooring that has to be smooth and level enough to ensure the safety and effectiveness of both the racking in the building, and that of the personnel and picking/sorting robots. If the concrete becomes defective, and no longer smooth, it becomes unsafe.

Additionally, the land surrounding the warehouse has to be stable enough to sustain the weight of frequent traffic from heavy goods vehicles. The integrity of flooring, and surrounding land, represents a risk not only for construction insurers but also for latent defects insurance (LDI) insurers, as their policies might not respond until 10 to 12 years post completion.

SUSTAINABILITY AND CLIMATE CHANGE

Increased sustainability is a source of competitive advantage, due in part to its ability to improve the energy efficiency of a building. For example, Bristol 360 Mountpark, in the UK, has been built to BREEAM (Building Research Establishment Environmental Assessment Method) specifications, with an EPC (Energy Performance Certificate) rating of A in order to reduce embedded carbon, and with the aim that, for tenants, an energy efficient building is more cost effective to operate. Failure to adopt sustainable construction practices could result in a developer having difficulties in letting out or selling their premises.

The large amount of energy required to both heat and cool warehouses, and to power the equipment, means many developments are being built with onsite renewable power sources, such as solar photovoltaic (PV) panels. Fires resulting from electrical faults are the most common cause of loss associated with roof-mounted solar PV installations, according to Zurich Insurance. In some cases, the fire has led to total destruction of the building.

Challenges arise from the varying quality of installation. While solar PV products must meet UK quality assurance standards, there are currently no regulations covering installation. In order to help mitigate fire risks, construction companies should develop an understanding of the technology and how it works, and arrange coordination between the roofing company and the PV designer/installer. Ideally, they should be the same company and adhere to industry best practice and regulations.

Heating and cooling can also be provided by air and ground source heat pumps. While both offer sustainability — and energy cost — benefits, problems arise if the installation is poorly designed and not matched to the energy needs of the building.

Attention also needs to be given to battery energy storage facilities for electric car fleets due to the risk of thermal runaway. In particular, storage facility control systems need to be closely managed and monitored to ensure that their potential failure does not allow overheating and fire to go unchecked.

As the climate gets warmer and wetter, heavy storms are no longer freak occurrences. As warehouses are now more automated, flood damage of transformers could interrupt operations for several days. Damage could also occur to goods and other equipment. That being the case, owners and developers should consider the location of the logistics centre and its elevation.

If the elevation that a warehouse is built at is no longer suitable for events to come, insurers are asking how clients are addressing the risk. Sound natural catastrophe modelling and risk engineering are capable of providing many of those answers, along with the installation of protections around the energy sources or at key entrances to the facility.

THE STATE OF THE CONSTRUCTION INSURANCE MARKET

The construction insurance market has gone through a clear transition, moving from a market that experienced stable or declining pricing for over a decade, to one in which prices have been rising, but with some moderation in terms of price rises from 2021.

The market is expected to remain challenging for the near future, with underwriters continuing to scrutinise each project in detail. Insurers will seek detailed risk information, which will undergo in-depth review. As ever, early engagement, and quality information remain key to attracting the optimum terms and premium.

HOW TO GAIN OPTIMUM INSURANCE TERMS

Work with a broker who has expertise in both construction and in wider specialties, including capabilities to properly respond to the challenging economic and business risks faced by developers. With their technical expertise, market knowledge, and close relationships with underwriters, brokers come into their own during a period of tightening insurance markets.

In order to gain the most effective insurance for their projects, clients should start working with their brokers as early in the process as possible, to ensure their contractual structure reflects the optimal insurance programme design and enables sufficient time for terms to be negotiated.

LEAD AUTHOR

Paul Hinton, FCII
Senior Vice President
Construction, Infrastructure and Surety, UK
Marsh Specialty

+44 (0)20 7178 4327
paul.g.hinton@marsh.com

About Marsh

Marsh is one of the world's leading insurance brokers and risk advisers. With over 35,000 colleagues operating in more than 130 countries, Marsh serves commercial and individual clients with data driven risk solutions and advisory services.

Marsh Specialty is our specialist division, committed to delivering consulting, placement, account management and claims solutions to clients who require specialist advice and support. Our local specialists work seamlessly with global experts, considering problems from every angle and challenging the status quo with entrepreneurial ideas and solutions. The service offering is enhanced with insight-driven advice supported by tailored data, analytic and consultancy capabilities to support clients in making important decisions about complex risks.

Marsh is a business of Marsh & McLennan Companies (NYSE: MMC), a leading global professional services firm in the areas of risk, strategy and people.