

Using Premium Finance to Address Complex Construction Issues

In New York, it's the final piece of a new \$4 billion bridge over the Hudson River, poised to open this year. In Ohio, it's a \$150 million wastewater storage, collection, and treatment tunnel. In California, it's a \$64 billion high speed rail project between San Francisco and Los Angeles and a \$2.6 billion football stadium a few miles from downtown Los Angeles, on track to be the most expensive sports venue in US history.

Across the country, building activity is soaring to new heights amid a resurgent economy. Mega-projects whose size is measured not in the hundreds of millions but in the billions are reshaping communities from coast to coast.

Yet construction can be a risky business, even in the best of times. Accidents strike. Subcontractors default. A major hurricane can wreak havoc with a project's schedule.

Savvy project owners and contractors dealing with major construction and development projects understand that robust insurance coverage is crucial to protect a project from the twists of fortune that can disrupt the most carefully laid out plans.

As projects grow ever larger, all the risks that come with any construction project are multiplied — as is the amount of money needed to secure adequate insurance coverage. But there's a solution that can help project owners avoid some of the pitfalls of traditional construction insurance programs while also freeing up cash flow and capital: premium finance.



Smoothing Out Cash Flow Rough Spots

While times have changed, the way project owners are typically required to pay for construction insurance hasn't. Insurance premium payments on major construction projects are often front-loaded at the start of construction before payments start flowing in. For mega-projects like stadiums and multi-billion dollar infrastructure and commercial projects, this upfront payment could easily run into the millions if not tens of millions of dollars.

Nor is it just the big upfront premium payment that project owners and contractors should consider. Those big premium payments siphon off crucial working capital that could be earning higher returns for owners. The substantial sums project owners and contractors must put up at the start of the projects is money that could be invested, with the potential to earn a healthy rate of return in the market.

With the help of premium finance, project owners can obtain comprehensive insurance coverage without triggering disruptive cash flow issues. Here's how it works:

- As a lender, a premium finance company pays the insurance premium, including any commissions, on behalf of the project owner, general contractor, or other client.
- The contractor or project owner agrees to repay the premium finance company according to a customized plan based on their business needs, not those of the insurance company. There is no need to tie up valuable assets as collateral. The insurance policy is the collateral, similar the way in which a car serves as collateral for an auto loan.
- The premium finance lender should also be able to lock down an attractive, fixed-rated payment plan, with interest rates typically ranging from 3% to 5%, that will provide certainty throughout the payment process. The payment plan can be easily structured around the specific cash flow needs or seasonality of a project.

Customized Payments

Two words spell the difference between a relatively smooth construction process and a really bumpy one: cash flow. On a big construction project, the contractor or project owner is often required to pay much of the insurance premium upfront, with another large payment or two later. A big upfront payment is obviously attractive to an insurer looking to minimize risks to its own bottom line, but it comes at a point on a new project when cash is generally limited, before payments come in for work done. But that is typical of construction insurance, with little or no coordination between when premium payments are due and a project's rhythm of work done and payments arriving.

By contrast, premium finance companies recognize that construction projects typically are staged in multiple phases in which start and end dates can easily shift. Working with a premium finance lender, a project owner or general contractor can match its premium finance payments with revenue coming in to ensure that cash flow is smoothed out from start to finish. Options include little or no upfront payment and a monthly and/or quarterly repayment schedule for as many as 36 months.

Freeing Up Capital and Preserving Borrowing Capacity

Insurance premiums on major construction projects, like a new baseball stadium or research complex, can involve upfront insurance payments in the tens of millions of dollars. Once project owners make those premium payments, this money stops working for them and instead goes to work for the insurance company. By going the premium finance route, project owners can hang onto this significant, often multimillion-dollar lump sum, and benefit from its use. That money, invested in the market, has the potential to earn significantly more than the interest paid on the premium finance loan, or it can be held back for other, project-related uses. Either way, the project owner or contractor retains the benefit of that working capital.

Premium finance also offers another big benefit: an unencumbered balance sheet. By working with a premium finance company, a project owner does not have to sacrifice overall borrowing capacity by drawing upon existing bank credit lines or other, established lending sources. In addition, the project owner or contractor is not required to pledge additional, valuable collateral in order to obtain a premium finance deal. Instead, the unearned premium serves as collateral for the loan. In this way, premium finance serves as a low-cost alternative that can enhance the organization's borrowing capacity without tying up existing credit facilities or sources of funding. There is generally no need for a Uniform Commercial Code (UCC) filing, either.

Expanded Protection

Ideally, how much insurance a project owner buys is dictated by the potential risks and the coverage needed to hedge them. But building a new hospital wing or stadium can be a very expensive endeavor, with lots of competing demands for finite financial resources. The result too often is that project owners buy the coverage they can afford, a standard which can fall short of what is needed to provide truly comprehensive coverage.

Gambling with insurance can be a risky business. And construction can be a litigious business; for any number of reasons, owners may be required to pay legal fees and later unfavorable judgements after finding out their insurance didn't cover a crucial flaw or a major accident. There is no lack of cases where project owners and contractors thought they were covered but weren't after failing to understand all the insurance policy exclusions. Ensuring your project has adequate insurance can mean overlapping policies to ensure the broadest possible coverage, including traditional weak spots like design errors.

Next Steps

If premium finance sounds like it could be a good fit for your project, consider these questions:

- Are there multiple demands on your project's cash flow that you will have to juggle alongside one or two large insurance premium payments?
- Are you confident that you are buying all the coverage you need? Or are your decisions necessarily limited to what you can afford to buy?
- Would the ability to spread insurance payments out over the course of your project — and avoid a large upfront payment — smooth out your cash flow?
- Are you concerned the collateral requirements of your project's insurance policy might encumber vital assets and hinder your ability to borrow from other lending sources?

If the answers to these questions are "yes," then it could be time to take some next steps. Consider talking to your insurance broker about premium finance or reaching out to a company that provides premium finance.

PREMIUM FINANCE SUCCESS STORIES

While premium finance deals don't get a lot of attention, a growing number of sophisticated project owners are using them. For example, a billionaire sports team owner was developing a new stadium for his hometown team. With a number of stadium construction funding deadlines looming, the owner decided to go with a premium finance agreement. Not only was the owner freed of the need for a big upfront payment, he was able to spread his premium finance payments over 21 installments, with a competitive rate as well. With help from premium financing, the owner was able to meet all the stadium budget deadlines.

In a second case, an insurer offered to allow a project owner to pay for a builder's risk insurance policy in four installments over a year. The project owner, however, didn't want to begin repayment until it began generating revenue for its project. A premium financing solution enabled it to defer the first payment for several months and spread subsequent payments out in quarterly installments over several years. As a result, the project owner was able to preserve valuable capital and maintain the strength of its balance sheet.

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