

# Home Replacement Cost Explained

The replacement cost of a home on a homeowner's insurance policy has always been a large part of the discussion among homeowners, insurance advisors, and insurance companies. This is due to the significant role a home's replacement cost plays in insurance pricing as well as its lack of correlation to other home valuation methods.

Let's say you purchased your dream home for \$2.5 million. The replacement cost is estimated at \$2 million. Six months later, your home is destroyed by a hurricane. Whole neighborhoods are destroyed. Demand, price for labor, and construction material costs soar, driving up the cost to rebuild. The actual cost to rebuild your home is now \$4 million, leaving you in a \$2 million deficit. Studies show that nearly two out of every three homes in the U.S. are underinsured by at least 18%. This means that if there is a total loss, such as a hurricane, fire, or otherwise, the homeowner may find themselves responsible for a significant portion of the rebuilding cost.

On the flip side, homeowners are sometimes frustrated in understanding why their replacement cost is higher than the purchase price of their home. For example, when a property they purchased for \$500,000 is required to be insured for \$600,000 or more. Insurance agents routinely find themselves answering the question, "*why is my home's replacement cost so high?*" And for good reason. Let's take a closer look at how this is possible.



## REPLACEMENT COST

How much it would cost to replace your home



Every home has three values at any given time. It is necessary to recognize all three to understand the insurance company's calculations, particularly the difference between actual cash value and replacement cost.

1. **Market Value** – This is the value any one individual or entity would pay you at any given time for your home, with fluctuations based on the economy. The insurance company isn't the slightest bit interested in the market value of your home. They stick with measurable constants, such as current cost for labor and materials and depreciation based on the functional life of any piece of property.
2. **Actual Cash Value** – This is literally the current value of the wood, nails, drywall, roof, brick, etc. The actual cash value of your home, known as ACV, decreases by the minute. Each day that passes, the physical materials which make up the construction of your home depreciate; do not confuse this with the value of a home depreciating.
3. **Replacement Cost Value** – This is the estimated cost to rebuild your home from scratch as it is now; including today's material and labor costs, removal of

debris from the initial loss, cost of permits and architectural drafting, among other things. However, if you don't insure to the full value of your home, you may find yourself responsible for a significant portion of the rebuilding costs in the event of a loss.

Insurance companies have the most accurate data regarding what a home costs to rebuild. *How?* Well, they are the ones who pay to rebuild every home that has ever been destroyed (assuming it was properly insured). Your insurer compares your home to the thousands of similar homes they have rebuilt and estimates the cost to rebuild yours accordingly.

#### What factors help determine the replacement cost of your home:

- Local construction costs
- Square footage
- Year built
- Exterior walls/roof/trim
- Style of home
- Number of bedrooms/bathrooms
- Garage
- Unique finishes
- Customizations
- Improvements/renovations
- Upgrades
- Ultra-high-end items

One of the major challenges with estimating replacement cost of a home is that there are many factors that could cause the replacement cost to

increase after a loss that are unknown when the replacement cost estimate is being developed.

#### Some of these factors include:

- Demand surge after a catastrophe
- New technologies being used in home construction
- Changing construction code requirements
- Limited availability of skilled labor after a catastrophe
- Government restrictions on site access enforced after a catastrophe
- Trends in materials costs
- Fluctuating fuel costs

In addition to the current upward trend in basic building costs, rebuilding a home is almost always more expensive than constructing a comparable new one. Local ordinances often place regulations on demolition that increase expenses sharply. In general, rebuilding sites are much less accessible than a vacant lot when it comes to moving and storing materials and equipment.

A major loss to your home is traumatic enough, but to not be able to recoup rebuilding costs could be devastating. It is critical to make sure you have necessary coverage. For over 50 years, Gulfshore Insurance has weathered the storms and we know how to protect homeowners against the perils of living in paradise. If you have any questions or concerns, please do not hesitate to reach out to me.

