Frank H. Ross

3RD EDITION

Pricing

for the Green Industry

To Bev, my loving wife and official editor, and Tom Farley, my friend and co-conspirator.

And to our children, McCall and Frank, who had the patience and good sense to occupy themselves when we couldn't.

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PRICING

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FOREWORD

I always looked forward to conversations with my friend and mentor, Dr. Emol Fails. He is a kind, gentle man, full of wisdom and humorous stories about contractors and the fixes they get themselves into.

He had a practice in his story-telling of throwing in a full dose of statistics. He would say, "Frank, do you know what the average level of profitability is in the construction industry?" I would shake my head, no. I had absolutely no idea, but knew in moments that I would. "One-half of one percent," he would say. "That's a fraction of a penny out of every dollar generated in sales!" Wow!, I would mouth to myself, careful not to look surprised for fear that he would feel I impressed too easily and wouldn't continue. So I would just nod, like — hey, I knew that.

"Frank," he would charge on, "did you know that the risks a contractor faces each day are greater than the risks you face at the tables in Vegas?" Well, I had never been to Las Vegas back then, but I knew by experience that putting me at a gaming table was like throwing money down a black hole. Again, I was impressed.

Also, by this time in the conversations, I would be equally impressed by the ash on Doc's cigarette.

Doc smokes. His doctor tried to get him to stop once, but his blood pressure went up so high, the doctor put him back on them — for medicinal purposes. When Doc smokes, he has a habit of not flicking the ash, and when he talks, he is very animated — his arms wave, he prances, stops suddenly, whirls, and charges off in another direction — and, incredibly, the ash, upward to two inches in length, remains intact.

My eyes would be glued to the ash while my mind braced itself to be wowed again by another of Doc's pearls of wisdom. "The average level of education in the construction industry is the eighth grade," he would continue. Where does he get these things, I would wonder, my eyes still fixed to the ash. "You'll never find a harder worker than a contractor — smarter, either. It's just that he never had an opportunity to be exposed to the intricacies of financial management. But," he would cry as he whirled around, pointing at me, "it's our responsibility to teach him, and teach him we shall!"

This announcement would initiate his launching into a halftime sermonette, the likes of which would make Knute Rockne proud. Even now, I can hear the sounds of the William Tell Overture welling up in the background. I am positive that these preachings were designed to send chills of commitment up the spines of us young bucks, and as you might expect, generally succeeded. The ash, meanwhile, had grown and showed no sign of weakness.

Perhaps the most astounding statistic Doc cited was that over twenty-eight percent of all bids were losers going in. 28%! That is one heck of a startling number. Small wonder the industry profit level is one-half of one percent if nearly a third of all jobs bid are losers. So, why does it happen? Doc's theory was that *most contractors are flying financially blind*. And that when they fly blind, it is virtually impossible to price jobs with any predictable accuracy.

"Pricing work," he would say, "is really quite simple. All you need is a budget, a decent accounting system, relative accuracy in estimating take-off, and a logical method for every job to recover its proportionate share of the company's overhead." Almost sounds too simple. It is. Yet, the reality is that too few companies have these basic tools, and in their absence the contractor has little hope of being able to prepare a logical price for the work he is about to perform.

This text, in a small way, pays homage to the message Doc Fails has preached to literally thousands of contractors all over the world. We are going to talk about pricing in just about every theater of the market and we are going to talk about what you need to do in your business to generate prices for everything you sell that accurately reflect your company's cost structure and methods of doing business.

Oh, about that ash — At the conclusion of every one of Doc's soliloquies, he would triumphantly take his cigarette, three inch ash still intact, and crush it into an awaiting ashtray. Then, he would look up with a twinkle in his eye, smile and say, "Thank you for your attention."

Thank you, Doc.

Frank Ross

PRICING

INTRODUCTION

You want to know what the scariest thing in the construction business is? It's bidding a job against twenty other companies, and then being notified that you're low!

28%! — This is the estimated percentage of bids in the construction industry which are *losers* going in!

Some people, given current market conditions, will argue this percentage is low. No matter — it is an astonishing statistic, particularly as the construction industry comprises nearly fifteen percent of the gross domestic product. This means that a lot of dollars are being generated just for the exercise.

Why do people bid jobs at a loss? A lot of reasons, I suppose. Some are valid, some are debatable, and some are just plain stupid.

First of all, there is a portion of the "loser bids," albeit a small one, which is intentional — that is, jobs which are bid at a loss but which have a *profit motive*. This is good business in my mind, and I heartily encourage the practice, so long as you have a firm grasp of timing and scope of what you are doing. Now, before you think that I've lost my mind, consider this rationale:

Valid Reasons

1. You anticipate that, for various solid reasons, you can make up any loss bid in the job through change orders or extras.
2. You are loss-leadering the first phase of the project with a reasonable chance of negotiating the next phase.
3. You are attempting to open a new market or expand an existing one.
4. You are intent upon keeping the competition away from a valued client.
5. You realize that the initial auction is for price verification only and that, after the award, the project's scope and numbers will change dramatically.

So, as long as you can identify your deficit going in and can control its downside, I don't have an argument with any of these reasons, for they all have a profit motive — but remember, we *are* pricing at a loss; therefore for this strategy to make sense, we must be able to visualize an opportunity to convert that loss into a profit.

Now let's look at some of the *debatable* reasons why you might be tempted to take a job at a loss:

Debatable Reasons

1. You are low on work. As a result, you rationalize that you need to pick up a few quick projects, even though they are losers, to keep your men busy until the market turns.
2. Cash flow has been tight and you need the revenue from new work to pay the bills from past projects.
3. You know the job makes no profit, but since it makes a contribution to the company's overhead structure, it's okay.
4. The project has great curb-appeal and can help you in your marketing of other work (the proverbial White Elephant).

These types of rationales bother me. They aren't so much profit-motivated as they are survival-motivated. Anytime I see a contractor bid work with this mindset, a caution flag goes up. Something is not quite right internally. You are trying to sell your way out of a problem. In this business, that is seldom a successful strategy. So before we start tampering with our bidding procedures and dig a deep hole for ourselves, let's figure out what's really wrong and fix it.

Nonetheless, I agree, they are on the debatable side — and I admit that I've seen instances where they can be decent solutions to situations — so, no argument. But these next reasons for bidding at a loss, no way!

Brace yourself for the really *bone-headed* reasons for bidding work at a loss. The scary thing is these are the guys we bid against more often than not.

Bone-Headed Reasons

1. You have no idea of what your costs are.
2. Your daddy used these prices for years. They worked okay then — why change now?

3. Because your inventory or equipment is already paid for, you no longer have to charge for it in your bids.

4. You bid "what the market will bear."

5. You just want that job!

No explanation is really needed for this kind of thinking, which explains why I've always referred to these reasons as the SWAG methods of pricing — *Scientific Wild Ass Guesses!*

Does This Sound Familiar?

Picture this all-too-familiar scene: An estimator comes into your office looking somewhat haggard and weather-beaten. Under his arm he has the roll of plans he has been working on day and night for the last week. In his hands is a thick folder containing the measurements, quantity take-off, unit costs, and extensions for the job. The bid is due in one hour, and he needs you to put the final blessing on the proposal. So, what do you do? You ask him a few questions about the job (this gives you credibility) which are answered promptly. You then excuse him. Now, you lean back in your chair, leg up on your desk, give the ceiling a blank look, and contemplate, "What's it gonna take to get this job? Hmmm . . ."

And, we wonder why 28% of submitted bids are losers!

What's wrong with this picture? Is management stupid? Most certainly not. *Ignorant* may be a more accurate term. Webster says that the word ignorant means *having little knowledge, education or experience*. This is what we have here. We aren't stupid. We are ignorant, ignorant of the financial relationships which are so critical for us to effectively manage our company.

Pricing is a Process

How do we improve this situation? The first step is to understand what is meant by the term *pricing*. Pricing is a process, a process that ultimately involves marking up the Direct Costs of what you are selling to recover your Overhead and to return a desired Profit. If you can identify all of your costs (Direct Costs and Overhead Costs) and the amount of Profit you want to make, you can accurately determine a price for your product or service.

The pricing process begins with the gathering of all of the necessary data to prepare an intelligent estimate

of the raw, out-of-pocket costs of what you are selling. Most people refer to this step as the *quantity take-off and extension* phase of an estimate. The result of this effort is a compilation of the *Direct*, or out-of-pocket, *Costs* of what you are selling — the cost of labor, material, equipment, subcontracts and general conditions you expect to spend to construct the job.

Step 2 in the pricing process is when you apply a proportionate share of the company's *Overhead* to what you are selling. This is an objective process, not a mere guesstimate based on the "experience" of the owner. All too often, I've seen where overhead recovery is treated as the prerogative, or whim, of ownership. As you might imagine, when a process is shrouded in mystery, behind closed doors, it probably means that no one knows what they're doing.

Okay, let's assume that you perform Steps 1 and 2 accurately. By adding Overhead to the Direct Costs of the job, you have calculated what is called the *Breakeven Point*. Breakeven is that theoretical sales figure at which you would neither make money nor lose money because all of your costs would be reimbursed to you exactly by your customer.

Step 3 is the final step in the process and is strictly focused on the word *Profit*. While Steps 1 and 2 document all of the costs for what you are selling, Step 3 determines how much Profit you wish to make.

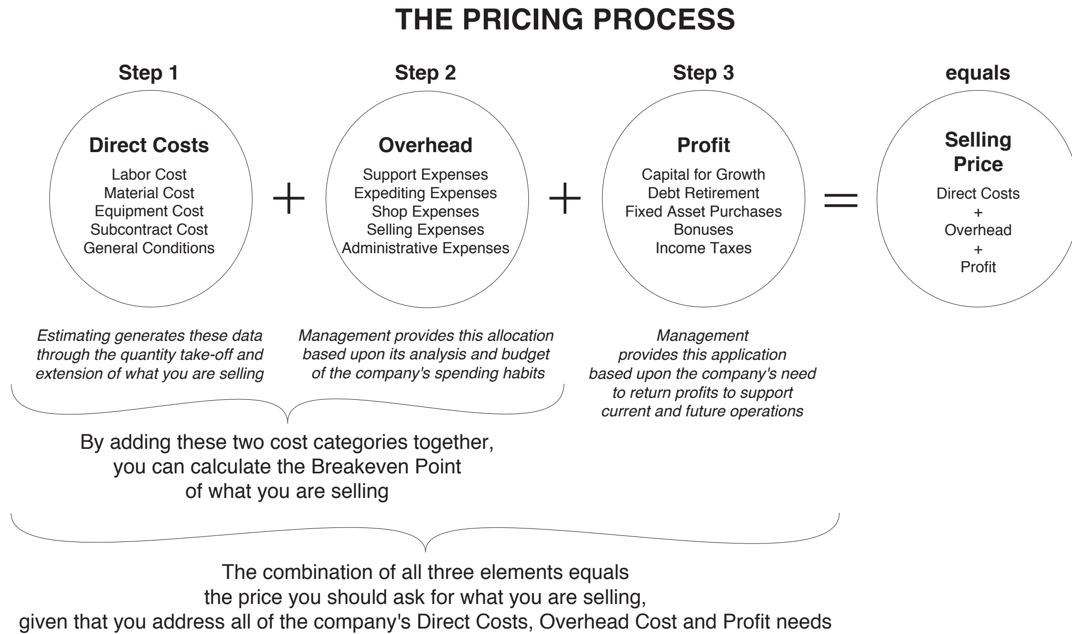
How Much Profit Should I Make?

Everyone always asks, "Frank, how much Profit should I make?" My first answer is always, "As much as you can." Then I become pragmatic and advise them that, while making as much as you can is great, there is a minimum level of Profit each of us *must* make. "Look at your budget," I say. "How much Profit do you need to honor your commitments to your creditors for the retirement of debt? How much Profit do you need to support the replacement of fixed assets in your equipment and trucking inventory? How much Profit do you need to support the cash flow required for next year's growth? What are you going to pay in taxes?" Answers to these questions will help you to determine how much Profit your company needs to apply, on average, to each job you bid.

The combination of these three steps is the Selling Price that you should receive when you sell your product or service. Using this Selling Price means that the job is neither

over-priced nor under-priced, but priced right to cover *your* needs for Direct Costs, Overhead and Profit.

Let's look at the following diagram and see how these three steps interrelate:



Our goal with this text is to walk you through each of these three steps such that you can develop the most appropriate pricing process for each type of activity in your company. Once you have developed the pricing strategy best suited for your type of work, you will then want to develop the *selling* strategy which will encourage your customers to buy from you rather than from the other guy.

My point is, the pricing process you will learn at this reading will not sell for you — that you will do with your own skills in selling and negotiating. What the process will do is tell you where you need to be priced if you intend to meet your individual job and overall corporate goals; and it will do that because it is focused to the cold, hard facts of how your company operates, not some smoke that has been handed down through the years.