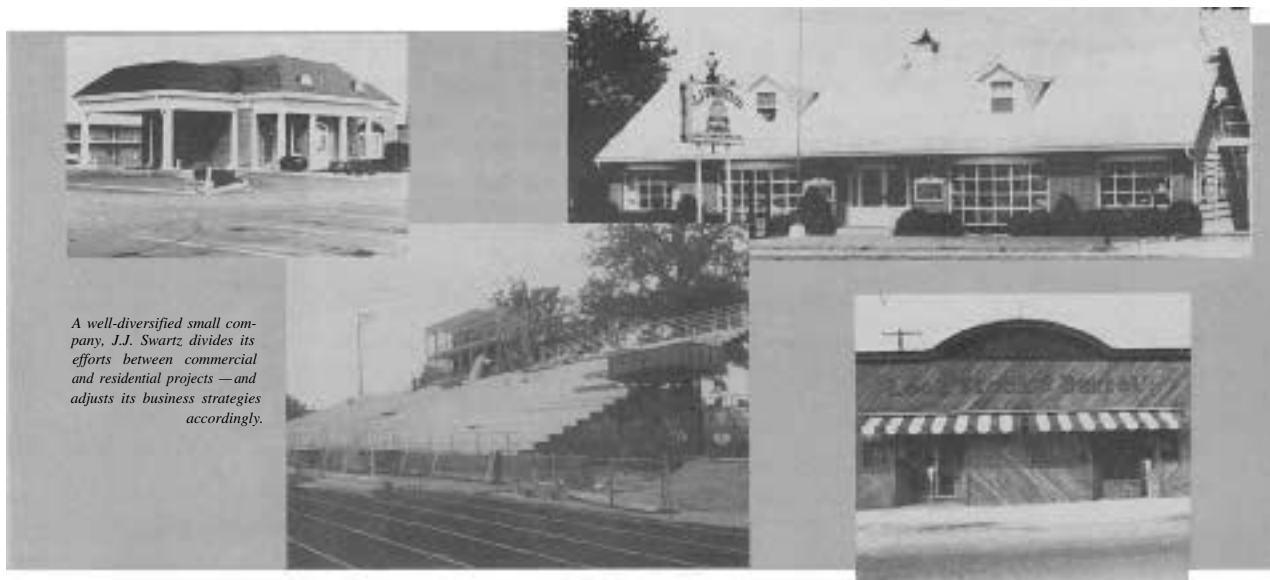


Planning for Profit in Commercial Remodeling



A well-diversified small company, J.J. Swartz divides its efforts between commercial and residential projects—and adjusts its business strategies accordingly.

Strategic tips on pricing, cash-flow and getting bonded

by Tom Swartz

Commercial remodeling is a natural market for the residential contractor wanting to diversify. But to make the move successfully you will need a new business plan, new goals, and an awareness of both the potentials and the pitfalls of light-commercial renovation.

Whether you do residential or commercial work, it's critical that you correctly account for administrative and overhead costs and accurately determine the proper mark-up and margin percentages. How each business classifies a given item will depend on how it affects their particular company. However, an item is a *cost* if it can be directly related to a particular job. Costs include labor and the related taxes and insurance, materials, and subcontractors. An item is an *expense* if it cannot be specifically related to a job. Expenses include office and administrative costs and everything else that is not a direct job cost. One direct job cost frequently overlooked is the labor of the company owner, if he works on the job with tools and materials. If you are a working contractor, don't forget your own labor.

If you do not have a specific *chart of*

accounts identifying the expenses and costs, you should develop one. It can be simple or complex, depending on your needs. However, you'll need one in order to track the transactions of the business.

Sales — Costs = Gross Profit
Gross Profit — Expenses = Net Profit
Expenses + Net Profit = Gross Margin
Gross Margin ÷ Costs = Mark-up %
Gross Margin ÷ Sales = Margin %

Many businesses fail to make the expected profit because it figures the percentage of margin on the direct costs of a job. It assumes that the percentages of mark-up and margin are the same. Many contractors confuse these because margin and mark-up are identical when expressed in dollars. The percentages, however, are different. Roth represent the difference between cost and sales price.

Selling Price: Selling price covers the direct costs, all the overhead and administrative expenses plus the net profit. The selling price is always equal to 100 percent.

Margin: The margin is figured on the selling price. It is a percentage of sales.

Example: The cost of a job is \$1,000 and our selling price is \$1,500. The margin is \$500, which is 1/3 or 33.3 percent of the selling price. The margin on this job would be 33.3 percent.

Mark-up: The mark-up is a percentage of the direct costs of the job. This percentage is used to "mark up" the direct costs in order to cover all the overhead and administrative expenses plus the net profit. Example: The cost of a job equals \$1,000 and we bid the job on a mark-up of 33.3 percent. The mark-up would equal \$333 added to the direct costs of \$1,000, which would result in a selling price of \$1,333.

In comparing these two examples on a job with a direct cost of \$1,000, a margin of 33.3 percent gives us a selling price of \$1,500, but a mark-up of 33.3 percent gives us a selling price of \$1,333. It is imperative to know the difference between these two terms and use them correctly.

The following is a chart showing a comparison of margins and mark-ups.

Margin required to cover expenses and net profit	Percent Mark-up of costs
25.0%	33.3%
27.0%	37.0%
29.0%	40.9%
30.0%	42.9%
33.3%	50.0%
35.0%	55.0%
37.0%	58.8%
40.0%	66.7%
42.0%	72.4%
50.0%	100.0%

On residential remodeling projects we typically price for at least a 33.3

percent margin. With overhead and administrative expenses averaging 28 percent and a net profit at 5 percent generally, this will give the contractor a comfortable profit margin. However, higher margins can be obtained with any of the following:

- Good control over production costs
- Good control over overhead and administrative expenses
- Professional sales techniques
- Professional business practices
- High value of customer relations

Getting healthy margins on commercial remodeling projects is sometimes more difficult due to more competition in bidding. The contractor must decide whether to take a project at a lower margin than usually needed based on the following:

1. Will the higher volume at a lower margin generate cash flow needed for a slower period of the business?
2. Will the taking of a job at a lower margin create future business at better margins?
3. How will not taking the project affect the business?

4. What are the risk factors in taking the job at lower margins? How accurately are the costs figured on this project? What is the margin for error, either in the production phase or in the estimating phase?

You must make the decision based on sound business practices that ensure making a profit. Do not just assume: "...this project will not increase my overhead or administrative expenses if I take it, so I can take it for nothing..."

You will find in commercial work that the specific costs of the project are locked in because of the use of more

subs. Therefore the risk factors are lower. Also, the sales volume is generally higher. Therefore a lower percentage of expenses to sales is required. This allows you to justify taking a job at a lower margin, yet maintaining the same net profit.

It is imperative that you determine the actual costs on a project before you submit a bid. On larger commercial projects, many of the general requirements belong in with the direct costs — because they are attributable to that job only. For example, the cost of the superintendent, telephone, and job trailer should be included in direct costs and marked up accordingly.

Also, don't shoot from the hip on the percentage you mark up your costs. Find out the exact percentage of expenses (overhead) you will need to recover, plus the profit you need to stay in business.

Payment Schedules and Cash Flow

Some contractors are hesitant to discuss payment schedules with prospective clients. They fear that discussing this will hinder or even lose a sale. On the contrary, this topic is as important to discuss and mutually agree upon as any specification listed in your proposal.

While discussing the payment process, the contractor can use another sales tool — *lien waivers*. The contractor can offer the customer lien waivers from his firm and from all major subs and suppliers. The customer will view this as a very professional procedure and a degree of protection that may not be offered by the competition.

Generally, you should include a payment schedule, with the proposal, in black and white. A typical schedule, based on a job costing \$100,000, would include payments of:

- \$10,000 at acceptance of contract
- \$10,000 at start of excavation
- \$10,000 at start of foundation
- \$25,000 at start of framing
- \$15,000 at start of drywall
- \$10,000 at start of trim
- \$10,000 at start of carpet
- \$10,000 balance upon completion of contract

On smaller jobs, we often charge 30 percent down, 30 percent at the start of the framing, 30 percent at the start of the drywall, and 10 percent at the end.

You may need to negotiate some with the owner on the schedule, but a mutually agreed upon arrangement will result.

Notice that each payment was at the start of some phase, rather than at the completion of the phase. This will keep the payments from being held up if a minor portion of the phase is not fully completed. An example would be if a bathtub was received damaged and was back-ordered, the drywall could proceed in the remaining areas, even though the rough plumbing was technically not complete until the fixture was replaced.

With a payment schedule like the one above, if small problems do occur near the end of a project, a small amount of money is withheld rather than a major portion of the contract. The problem could be a light fixture that's not acceptable, weather conditions that do not allow for landscaping, or problems with the carpet. Now the contractor can wait until the problem's corrected without suffering a financial burden. Set your payment schedule so that no more than 20 percent is the final payment. Ten percent is preferable.

Residential customers are generally accustomed to paying for services as

they are provided. In many instances, a payment is waiting for the contractor to pick up as the phases begin, as the customer is very anxious for the completion of the project. Commercial customers also are usually willing to pay partial payments on work completed. With commercial customers, however, the timing of payments may need to be discussed, as some institutions can only draft checks at certain times of the month. If this is the case, find out when to submit your progress payments for the fastest turn-around on your payments. For example, if your customer pays on the 10th of each month you may want to bill on the work completed on each 25th of the month. Let your subs and material suppliers know that they must also have their bills to you at, say the 20th, so they can get paid on the following 10th. With a pre-determined payment schedule progress payments are made as a normal routine in the production schedule.

A good payment schedule helps with cash flow. Getting a down payment and progress payments will allow the contractor to buy effectively, take advantage of discounts when offered, keep the subs happy by prompt payment, and possibly gain some additional interest income for the project.

Each payment is at the start of some phase, rather than the completion. This will keep payments from being held up if a minor portion of the phase is not completed.

By making the payment schedule a part of the proposal, it becomes standard procedure and not an obstacle to the sale. Our company policy warns "...if it's difficult to collect in the beginning...you can be sure it will be difficult to collect in the end..." This holds a great deal of truth in today's marketplace.

Remember, progress payments are also a check on your quality of work. If there is a problem, you will know about it when a progress payment is not made. It is imperative that the flaws in workmanship are corrected immediately, so that the project and the progress payments can get back on schedule.

Bonding

Get ready for a whole new world. Gone are the days that your reputation and references were enough to give the customer the confidence to use you as their contractor. Many commercial jobs, especially those with prevailing wages, require a Bid and Performance Bond. These bonds are provided by an insurance company that assures the owner that the job will be completed if you, the contractor, can not complete the job due to death, bankruptcy, or failure to perform.

A contractor must start early to gain the confidence from the insurance carrier that will provide the bond. Call your insurance agent to find out what specifics he will require for financial and business information. In general, you must provide the bondsman with:

- A record of past performance on jobs
- Current profit/loss statements
- Profit/loss statements for the past three to five years
- Balance sheets
- Proof of financial liquidity
- Lines of credit at a bank
- Evidence that you can get the job

done with crews, equipment, technical ability in your company, and the administrative ability to run the job and keep necessary reports.

The limit of your bonding will have a lot to do with your past work loads and what major jobs your company has completed. A full disclosure, placed in a neat set of exhibits, will go a long way with the bondsmen.

Start with smaller bonded jobs and work constantly to increase the line of bonding you can achieve. If a larger job comes up that you want to bid on, you may need to seek alternatives in achieving the bond. This will include:

1. *Joint venture* — talk to a lumber dealer you work with to see if he has an interest in joint venturing the project. He will get the sale of the lumber and materials as well as 25 percent (and in some cases 50 percent) of the net profit from the project. Be sure to get a joint-venture agreement in writing on each project.

2. *Sub-bonding* — get your subs on the job to bond their part of the project. You can also get them to give you a letter of credit for their part. This will

assure that they perform the job as they now have a financial stake in the project.

Bonding through joint venturing and sub-bonding will cost you more, thus lowering your margins. You must weigh the increased risk factors and the lower margins vs. larger volumes and more secure work to see how they fit your company's overall business plan.

Although the commercial remodeling business can at times seem very frustrating, it can also prove to be a very profitable business. Instead of dealing with Harry Homeowner, you are dealing with business people much like yourself.

When you are able to provide expert service and achieve the gross margins to make a profit, you will find commercial renovation a rewarding market. Remember to set up your payment schedules for good cash flow. And start today to prepare for tomorrow's bond. ■

Tom Swartz operates the J.J. Swartz Co., in Decatur, Ill., which has 65 years of experience in all phases of residential and light-commercial construction.