Pricing for PROFIT

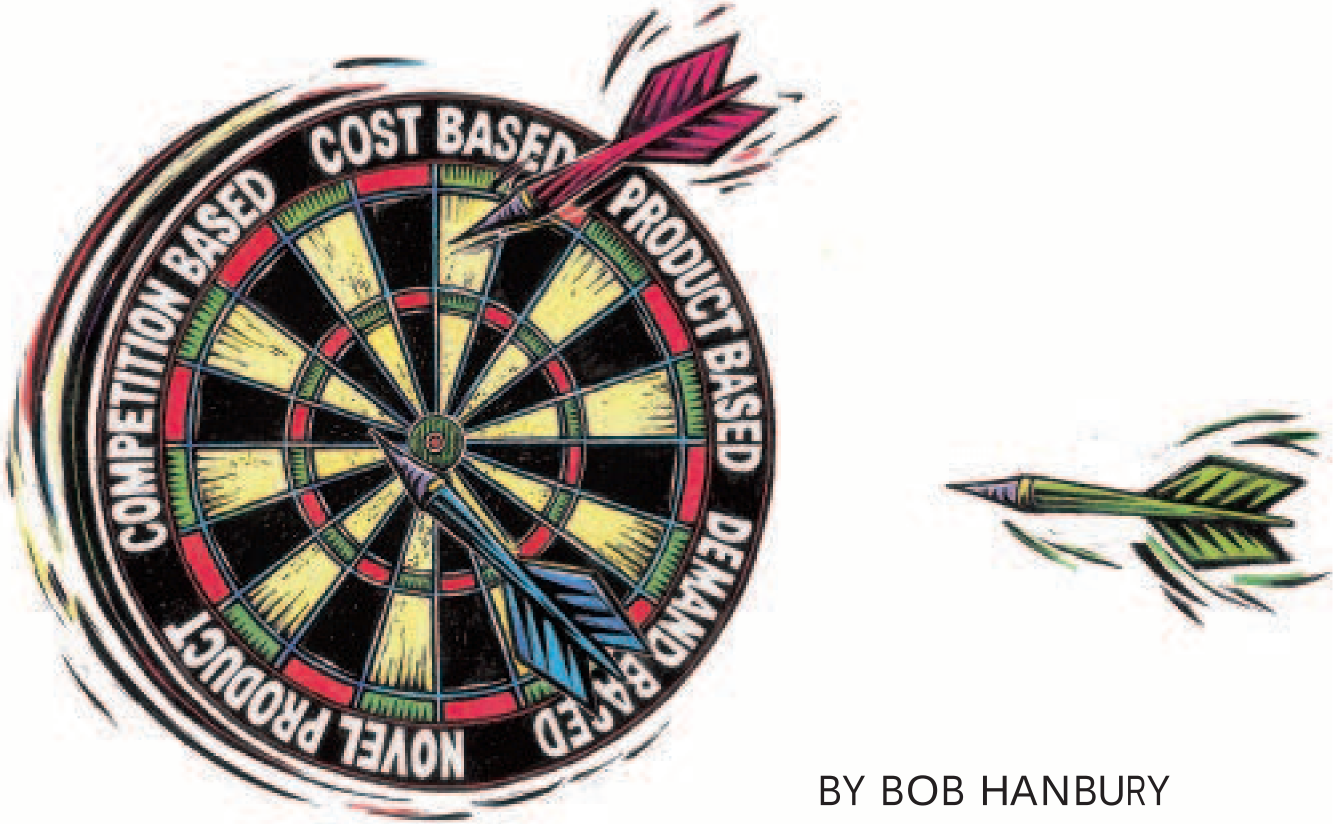

ILLUSTRATION BY MOIRA NORTH

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Five strategies for winning jobs *and* making a reasonable profit

Many contractors consider estimating and pricing to be the same thing, yet the two are entirely different. A job's price should be shaped not just by the estimated cost, but by your assessment of the customer, the market, and most important, by your own need to make a reasonable profit. Until you recognize these differences and master the "art" of smart, profit-driven pricing, you will not be able to make money consistently.

Unfortunately, few contractors understand the several different pricing strategies available. Big corporations have full-time employees who figure out what price a widget must carry to increase market share, generate the largest net profit, and beat the competition. This is not always the lowest price, and the cost of producing the widget is often a secondary factor. Contractors need to do the same thing when pricing their work.

A Lesson In Pricing

To survive in business, you must not merely cover your costs, you must make a profit. Profit provides a return on the money invested in the company, generates funds for further investment, and provides a cushion to absorb bad markets, sudden expenses, or unexpected opportunities. To fail to provide for profit is to subvert all business logic, and to leave you, your employees, and your suppliers at needless risk.

I learned the hard way that the lowest price isn't always the best price — even from the customer's point of view. About 14 years ago, when I was just starting out, I prepared an estimate in my usual way for a nice remodeling job, and submitted a bid of $72,000, including a 5% profit. After learning that the other two bids came in at more than $112,000, I went to meet the customer, expecting good news.

Instead, the customer told me he simply couldn't believe I could do the work for that price, so he was going to go with one of the other contractors at the higher price.

When I got home, I did a postmortem on the dead proposal with my partner, who is also my brother, to see what went wrong. We discovered that in our eagerness to come in with a low but realistic price, we had neglected some important factors. We found out, for example, that the owner was president of a Fortune 500 subsidiary division, who personally earned in one year what our whole company did — about $250,000. We also learned that rather than being called in from left field to place a bid, we had been heartily recommended by the already-retained kitchen designer. The other two bidding contractors — both old-line, upscale remodelers with great reputations and extensive work experience, as well as the highest hourly rates in the county — had also been invited to bid the job.

When we drove through the neighborhood in the daytime (our previous visits had been at night because the owner always worked late — another vital fact I ignored), we realized that the house was in an exclusive and expensive neighborhood flanking a golf course. The kitchen designer told us that the job's lead "designer," who had introduced himself simply as a friend of the owner, was in fact a senior partner in the largest architectural firm in Connecticut. Finally, the kitchen designer (who turned out to be from another prestigious firm that had won national design awards) explained that the client's last remodeling job had run into many problems, and that he was worried far less about the job's cost than about running into hidden problems and delays.

None of this had anything to do with our ability to do the job at any given price. Yet it could have affected the way I treated the scope of the job. Instead of considering the owner's expectations about price, quality, and service, I priced the job based on my idea of what was involved and what the costs might be. As a result, my low bid cost me a chance to do a high-profile, high-quality job that might have led to others.

The lesson was valuable. I learned — in a way that stuck — the importance of knowing what my clients want and of learning about their personalities, their values, and their positions in the community and at work. I also learned the importance of evaluating what the presence on the job of other building professionals — architects, kitchen and bath specialists, interior designers — implied about the owner's values and expectations. Simply put, I discovered strategic pricing.

Choosing the Right Pricing Strategy

After this expensive lesson, I read a lot about pricing strategies, and thought about ways to generate a price that balanced the possibility of getting the job with the certainty of making a profit. I came to see that the challenge in pricing lies not just in winning jobs, but in winning jobs that will make money.

Winning such contracts requires choosing one of the following five pricing strategies for each job:

- cost-based pricing
- competition-based pricing
- cover pricing
- demand-based pricing
- novel-product pricing

If used properly, the first three — cost-based, competition-based, and cover pricing — should generate a reasonable, if often modest, profit on almost every job — what I call "profit satisfaction." The last two, demand-based and novel-product pricing, can generate more profit than usual on some jobs while still satisfying the customer. In fact, because they can achieve maximum profit, you should never fail to use them when they are called for.

I will focus here exclusively on fixed-price jobs. "Cost Plus" and "Time and Materials" pricing techniques tend to focus attention on a job's price rather than on its quality.

Cost-Based Pricing

This is the most common pricing strategy. Usually, the price is the result of adding gross profit (overhead plus a target net profit) to estimated costs. When contractors use reasonable "markups" or "margins," cost-based pricing satisfies reasonable profit goals. Unfortunately, many contractors don't include enough of a gross profit margin above the direct job costs, either because they don't know what their overhead is or because they don't recognize the need to make a profit on every job. Along with poor estimating, such inadequate margins are the main reason many contractors fail to make money.

Target pricing. This is a second type of cost-based pricing, in which you know (or guess) the budget allowed for the job, then figure out whether you can do the job for that amount. If you can, you bid right at or below the budget, knowing you can make a profit; if you can't, you don't bid the job. This strategy can also yield consistent (if modest) profits, but only if you don't succumb to the temptation to price too low.

By either method, successful cost-based pricing requires accurate historical job-cost records and an accurate estimating system. It also requires that you understand and control your overhead. Finally, it requires that you write proposals that leave no ambiguities or voids in the scope of work. If you do all this, you can steadily win jobs that satisfy a reasonable profit demand, even in slow markets. The downside is that even if your estimates are dead accurate, cost-based pricing is not a good tool for winning potentially high-profit jobs.

Competition-Based Pricing

This strategy sets prices primarily in relation to competitors — either the competition in general, or other contractors bidding on a given job. A competitor in your area, for instance, may heavily advertise a certain price for a product or service that is essentially the same as yours. You will have difficulty selling your product for more than that advertised price unless you can somehow distinguish your product.

Sealed-bid pricing is another form of competition-based pricing. You don't know your competitor's bid, of course, but your own bid price will be based largely on your guess about what your competitor's will be, leavened, I hope, by a realistic assessment of how much you can do the job for.

Competition-based pricing can

yield profits if you resist the temptation to underbid contractors who don't offer your level of quality and service, or who themselves fail to use adequate margins. Good competition-based pricing requires knowing your competition well — their work load, their ability to do the job, their lead time, and any ties they have to the owner. You must also know those things about yourself, for this pricing method will devastate the contractor who does not know or cannot control his own costs and merely reacts to other contractors' prices. Never lower your price unless you can make up the difference by getting cost concessions from your subs or suppliers.

Cover Pricing

Cover pricing, also known as "courtesy bid" or "cover-your-ass" pricing, is a defensive strategy used to guarantee a profit. Its use is limited to jobs you don't really want or which you know have high potential for trouble, as when a customer gives you bad vibes, the job requires too much travel, or you don't have time to do the work but it's for the friend of a good customer. Cover pricing may also be useful when you can't give an accurate price because there isn't enough time to get firm quotes from your subs and suppliers.

The goal of cover pricing is not to gouge the customer, but to add enough money to the price — say, an extra 10% to 15% — so that if you indeed win the job, you'll either make some extra profit or have enough margin to absorb any problems.

Demand-Based Pricing

This strategy, common to markets in which demand is high, is based on what the market will bear. It aims explicitly at achieving maximum profit. Demand-based pricing sounds mercenary, but in reality it is an opportunity to make up for the jobs in which for some reason you made less profit than you expected.

Demand-based pricing works best in strong or growing markets. I believe that in such markets you should raise prices across the board for all jobs — at a rate of, say, one percent a month, until your rate of closing deals begins to drop.

Demand-based pricing is probably the best way to achieve maximum profits, but you must be certain your market is strong, and you must know a lot about the particular job you're seeking. This includes knowing the owners' expectations about quality and service, their priorities, their social and economic standing, and the roles of other professionals working on the job — all of the factors I failed to consider in my bungled Fortune 500 job.

But demand-based pricing is more than simply pricing high on country-club jobs; you can also gain maximum profit if you accurately assess the desires and expectations of a young middle-class family adding a room or remodeling a kitchen. Don't gouge the customer, but charge a price commensurate with their desire to have you do a particular job at a particular level of quality.

To determine how much net profit

Profit and Probability

The best price for a job isn't necessarily the price most likely to win the job, nor is it always the price that will produce the most profit. A low price will win a lot of jobs, but at very little profit, if any. A high price will produce good profit, but has little chance of winning the job. The best price is somewhere between the two — a price in which the net profit margin is both adequate and has the highest probability of winning the job.

Don't guess at the probability of winning a job: Figure it out from your bidding history. First, count the number of past jobs you won at various net profit margins (1%, 5%, 10% net profit, and so on). For each net profit margin, divide the number of jobs won by the total number of bids — that's the probability of winning the job at that profit margin. For example, if you win one out of every three jobs you price at 5% net profit, the probability of winning the job at 5% net profit is 33% (1÷3).

I win about 81% of the jobs I bid at 1% net profit, about 30% at 6.3% profit, and about 10% at 12% profit. Which net profit margin makes for the best price? I use the following formula to test the probability of winning a job at various net profit margins:

Net profit x Probability of winning job = Effective profit

Using the formula to compare various prices (see table at left), I can see that my best price is one with a net profit of 6.3%. If I bid that way consistently, I know I'll lose two out of three bids, but the ones I get will yield good profits.

— *B.H.*

Finding Effective Profit

Bid Price	Planned Net Profit	Probability of Winning	Effective Profit
$9,000	–$400 (–4.3%)	.99	–$396
9,500	100 (1%)	.81	81
10,000	600 (6.3%)	.30	180
10,500	1,100 (12%)	.10	110
11,000	1,600 (17%)	.02	32

Note: The chart assumes a job for which the estimated cost — without net profit — is $9,400. Effective profit for each bid price in column one is calculated by multiplying the Planned Net Profit by the Probability of Winning. The best price — $10,000 — is the one with the highest effective profit.

Additional Work Required When You Drop Your Price

This chart shows how cutting your price increases the total volume of work you must do to earn the same net profit. For example, if you cut your selling price 10% and your present gross profit margin is 25%, the chart shows that you will need to sell 67% more work to earn the same gross profit margin as you would have earned at full price.

Price Cut	Present Gross Profit							
	5%	10%	15%	20%	25%	30%	35%	40%
1%	25%	11%	7%	5%	4%	3%	3%	3%
2%	67	25	15	11	9	7	6	5
3%	150	43	25	18	14	11	9	8
4%	400	67	36	25	19	15	13	11
5%	—	100	50	33	25	20	17	14
6%	—	150	67	43	32	25	21	18
7%	—	233	88	54	39	30	25	21
8%	—	400	114	67	47	36	30	25
9%	—	1,000	150	82	56	43	35	29
10%	—	—	200	100	67	50	40	33
11%	—	—	275	122	79	58	46	38
12%	—	—	400	150	92	67	52	43
13%	—	—	650	186	108	77	59	48
14%	—	—	1,400	233	127	88	67	54
15%	—	—	—	300	150	100	75	60

to seek with this method, you must also know a lot about your own company — the average gross profit per job, the number of promising sales leads, and, most important, your rate of closing sales at different net profit margins (see "Profit and Probability"). Armed with this knowledge, you can bid intelligently at higher prices.

Novel-Product Pricing

If you can offer a unique or distinctive product or service, you're in a position to use novel-product pricing. Ideally, a novel product is a patented product, service, or franchise that only you can offer, but it can also be something for which you've staked out a territory. If you're the only contractor who knows how to build floating staircases or cantilevered decks, or if you've got the only plaster-and-paint crew in the area who can produce that trendy Mediterranean look, you can name your price to the customers who want those products. The novelty usually lasts only so long, however, as other contractors make an effort to learn the needed skill, or, in the case of a patented product, the patent runs out. For that reason you should try to achieve maximum profit during the time you exclusively offer the distinctive product or service, while maintaining quality in your other work to build a strong general reputation.

Putting It All Together

With these strategies in mind, you should be able to intelligently price any job. But we all fail to do so at times, either because we don't know our costs, or because we lose our nerve and price too low. So as final inspiration, I offer this multiple-choice quiz, with answers based on the actual alternatives that flash through most of our minds when we sit down to bid a job.

Question: Which of the following is the best pricing strategy for a given job?

A) Bid within the customer's stated budget figure. *A huge mistake unless your own costs and gross profit margin allow it.*

B) Drop your gross profit target to get this job. *An even bigger mistake. When you get the urge to do this, look at the chart above. Climbing back from a low-profit or no-profit job is like trying to raise a grade-point average in school — if you get one bad grade, it takes a lot of good ones to make up for it.*

C) Bid the "going price," regardless of your cost. *Fine if the going price allows room for your gross profit; trouble if it doesn't.*

D) Use a rational pricing strategy that will ensure a reasonable profit — and still get enough jobs. *Enough said.*

Obviously, my quiz is rigged, but pricing intelligently is more than an academic exercise; it's the difference between struggling and prospering. The contractor who learns not to price down, and who understands that not every job is worth winning, is the one who will keep working and enjoy doing it. The others are doomed to struggle. ■

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