Strictly Business

Margin Math 101

by Shawn McCadden

Many magazine articles advise contractors to apply a "professional markup" to their bids. But what, exactly, is a professional markup? Does a 50% markup make you a professional, or should you apply 67% to qualify? The simple answer is, if you don't know what markup your company needs to use, you're not a professional, and therefore you're not using a professional markup. But if you know the formulas for determining margin and markup, you have a working financial tool, rather than a magic number suggested by some remodeling guru.

Different Markups, Same Price

To determine your company's markup, divide your anticipated annual indirect costs (costs of overhead and profit) by your anticipated annual direct costs (costs to produce projects):

Company A
Annual indirect costs of $150,500
÷ annual direct costs of $475,500 = 32% markup
Total cost of sales $626,000

Company B
Annual indirect costs of $100,000
÷ annual direct costs of $526,000 = 19% markup
Total cost of sales $626,000

Thus, if one company considered its field employees' health insurance a direct cost, and another company defined it as an indirect cost, those companies would apply different markups. In theory, if both companies had all of their other costs covered somewhere within their annual budget or estimate, they'd sell their projects at the same price, even though their markups differed. Remember this the next time you're impressed or puzzled by what your fellow contractors claim to be using as a markup.

Targeting Your Margin

To determine the margin your company needs to maintain while completing projects, divide your budgeted annual gross profit amount by your total anticipated sales:

Company A
Gross profit = $150,500
Annual sales = $626,000
150,500 ÷ $626,000 = 24% margin

Company B
Gross profit = $100,000
Annual sales = $626,000
$100,000 ÷ $626,000 = 16% margin

To see if a single project met your goals, apply the same analysis. Divide the gross profit by the amount of money you collected at the end of the project. The result will be an expression, as a percentage, of your gross profit margin for that job. Here are the numbers for Company A:

Estimate:
$100,000 direct cost + 32% markup (100,000 x 1.32)
= $132,000 sell price

Job cost:

Whole-house remodeling sales price:	$132,000
Direct costs to complete the project:	–$100,000
Gross profit:	$32,000

Margin:
$32,000 (gross profit) ÷ $132,000 (sell price)
= 24% gross profit margin

Create a Budget

If another contractor tells you that he or she expects to do "somewhere between $1 and $2 million" in volume for the current year, don't be impressed. The ambivalence is a potential disaster sign, and certainly an indication that that contractor doesn't have a budget.

Working successfully with markup and margin percentages requires that you maintain accurate estimates of your direct costs, indirect costs, and a targeted net profit amount — in essence, a budget. By adding those three components together, you determine your anticipated sales volume. But say you have a slow year and don't actually spend as much on direct costs as you estimated. (Keep in mind that your indirect costs will probably remain the same.) If you don't increase your markup as you see this happening, you won't collect enough money to fully cover your gross profit requirements. That in turn reduces your net profit and may mean that you won't cover your indirect costs, either.

Volume vs. Profit

I consider profit to be my reward for the risk I take by using other people's money to produce projects. After all, if my estimate falls short, I'm still responsible for completing

the project, and may even have to contribute some of my own money to cover costs. I once had a conversation with another well-respected remodeling contractor in my hometown who bragged that his volume was twice that of my company. Then I asked him about his net profit percentage, and I wish I had a picture of his face when he discovered that his percentage was half of mine. Although we made about the same net profit in actual dollars, I had half the risk.

If you want to make a bigger profit, first consider raising your prices on your current volume. Only after you reach your profit goals on your current volume of work should you consider producing more work.

If this year's budget includes the same dollar amounts for your direct and indirect costs as the previous year's budget, but you want to add profit to the budget, then your sales volume will have to increase. You won't need to produce any more work, but you will need to sell it at an increased markup and a higher price than last year.

Trade-offs

Keep in mind that the total annual dollar amount of the direct costs in your budget must remain the same if your markup doesn't change. But the actual breakdown of expense accounts that make up the total can change: If your burdened labor costs go down by $56,000, but your subcontractor costs go up by the same amount, you'll still be on budget.

Knowing this, you can explore options: If you increased your material costs by specifying and using higher-priced products, you could possibly reduce your burdened labor costs proportionally without compromising gross profits. For example, if you switched from being a vinyl siding contractor to being a kitchen and bath contractor, you might boost your volume without needing to hire additional employees. After all, the typical cost of materials for a $20,000 vinyl siding project is much lower than the cost of materials for a $20,000 kitchen remodel. This scenario assumes, of course, that your employees have the required skills to make the switch, or that you replace them at a similar burdened labor cost.

Tracking Gross Margin

Be careful when determining your company's overall gross profit margin for completed projects. I once made the mistake of adding up all the margins for each project, then dividing that total by the number of projects. Trust me, it doesn't work that way. That method could indicate a healthy margin when, in reality, you're in big trouble. Let's say you do five projects and want to determine your true overall gross margin. The correct method is to add up all of the money you paid out to complete the five projects and then divide that sum by the total of all the money collected for those same five projects.

Incorrect Method for Calculating GPM

Job 1:
$10,000 – $6,000 direct cost
= $4,000 gross profit or 40% GPM

Job 2:
$12,500 – $8,000 direct cost
= $4,500 gross profit or 36% GPM

Job 3:
$32,000 – $24,000 direct cost
= $8,000 gross profit or 25% GPM

Job 4:
$8,000 – $6,000 direct cost
= $2,000 gross profit or 25% GPM

Job 5:
$1,000 – $300 direct cost
= $700 gross profit or 70% GPM

"Average" GPM = 196% ÷ 5 projects = 39.2% GPM

Correct GPM Method

Total sales for 5 jobs = $63,500
Total direct cost for 5 jobs = $44,300
Total gross profit for 5 jobs = $19,200

Overall GPM = $19,200 ÷ $63,500 = 30.2% GPM

The two examples show a difference of 9 percentage points. For a company doing $1 million in annual sales, that difference amounts to $90,000 in gross profit. If you used the first example to determine gross profit, you'd assume you'd earned way more than you actually did — at least until you thought about paying for your true overhead and profit. I guarantee you would make this mistake only once!

Shawn McCadden *is president of Custom Contracting in Arlington, Mass., and cofounder of the Residential Design-Build Institute, LLP (www.designbuildinstitute.com).*