Healing Your Inner Underestimator

by Paul Eldrenkamp

In our industry, underestimating is far more prevalent than overestimating. This is due in part to human nature — the "hope springs eternal" phenomenon. But it's a serious problem: Not covering your costs because of a low estimate jeopardizes your ability to do a good job on behalf of your client. Ironically enough, undercharging causes more damage to our industry's reputation than overcharging. Ninety percent of the struggling contractors I talk to are struggling not because they're bad builders or have no work, but because they're hemorrhaging cash and thus lack sufficient resources to get out of the hole they're in. They blame their crews, they blame their competition, they blame the weather, their subs, whatever — they blame everything but their estimates. But all too often, that's where their troubles began.

I wish there were a more flattering root to the problem, but the three main reasons contractors underestimate project costs are laziness, ignorance, and fear.

Laziness

Let's face it: For most people, estimating is boring — especially if you're the business owner and have a lot of distractions and conflicting priorities. It's amazing how many other urgent, useful things I can find to do around the office when I'm supposed to be estimating. No matter how slick and powerful your estimating system, you still have to do takeoffs and enter data. And in order to obtain some of the data, you have to set up job-site visits with subs and suppliers and then hunt down their proposals afterward. It can take a huge amount of time out of a contractor's day.

Furthermore, since most contractors still bid competitively, they find themselves providing estimates of several times more projects than they could possibly hope to build. This just adds insult to injury.

To save time when doing an estimate, it's really tempting to take the easy way out and "guesstimate" some line items or be so cavalier with the data it's as if you were fabricating numbers: "I think this plumbing should cost $5,000." Or, "Let's see — that's probably about $4,000 worth of siding there." And so on. It's quick and easy, but so is stepping off a cliff.

The real problem with fabricated numbers, however, is that they're almost certain to be lower than real numbers.

Another consequence of laziness is that we don't think the project through thoroughly. We get the subcontractor quotes, but we don't analyze them in sufficient detail to know what they actually do and, more important, do not include. We happily plug the number into the spreadsheet, thrilled that at least that line item is dealt with, oblivious to the fact that it represents only half the required work. And we treat material quotes just as casually: We don't discover until delivery that the windows have no factory-applied casing, thereby losing ten hours of lead carpenter labor via ten seconds of inattention.

So how can you keep estimating laziness from doing terminal damage to your business? Choose from among the following suggestions:

- Hire an estimator. This position can be self-funding. If your slippage (difference between actual costs and estimated costs) is $60,000 a year (not a stretch for a $1 million company), an estimator who costs you $45,000 a year but gets that $60,000 slippage down to $5,000 is making you $10,000 a year — not a bad return on investment. When you factor in the time you've saved, the payback is even more significant.

- Work exclusively on a time-and-materials basis. With this strategy, you just need to make sure once a year or so that your labor rates and margins are adequate. Time and materials can be a hard sell with a client, but it's much safer for you: You may lose some jobs, but you're probably better off losing them.

- Increase your gross margin. Say your estimated margin is 33% (via a 50% markup), but estimating problems consistently cause that margin to slip to 25% by the end of the year. Go ahead and maintain your current estimating "system," but increase your markup to 70%, to yield a theoretical 41% gross margin. If that 41% margin slips by 8% or so, you'll still be left with a 33% margin. This is a crude but generally effective method. And it buys you time to make more rigorous, professional changes to your estimating procedures.

The problem with "guesstimates" is that the numbers are almost certain to be lower than real numbers

Ignorance

An estimate is an attempt to predict the future. Prospective stock investors are typically warned that past performance is no guarantee of future performance. In job-cost estimating, however, past performance is just about all you have to go on. The better your historic cost data — and the better your understanding of it — the better your predictions will be about how your next jobs will go.

> *The act of being honest with another person may force you to be more honest with yourself*

But we're too often utterly ignorant of our past cost data. We either don't track job-cost data, or we track it but don't analyze it. Because we don't compare budgeted costs to actual costs, we're oblivious to the fact that we're consistently estimating framing labor and materials about 15% low, or that we consistently need to add three days of our labor to the demo sub's quote to cover our actual demo costs, or that flooring installation costs have snuck up $2 a foot.

If you have no idea how you're underestimating projects, you have only a random chance of correcting the errors. To learn where they are, you need to do job-cost accounting. You need to have a clear and thorough estimate going into a job, and at the end of the job (eventually, *during* the job), you need to compare your actual costs with your estimated costs. There's no way around it. The longer you avoid making this a standard, disciplined, ongoing business practice, the longer you will lack an accurate idea of what it costs to produce your projects and the longer you'll run the risk of underestimating those costs.

Here are some ways to overcome ignorance-induced underestimating:

• Have vendors do as much of your estimating as you can. Sub out more components of a job (so presumably more experienced, better-informed subcontractors are generating your estimates), and keep good track of what those subcontract prices are. Have lumberyards do your material takeoffs, and pay close attention to the data they generate. Ask if someone there can help you track how close their estimated materials were to the actual materials you ordered for a given project. This may benefit the lumberyard as much as it benefits you.

• Make it a key part of your bookkeeper's job description to generate profit-and-loss statements for each project, regardless of the quality of the estimate you generated going into the job. If your crew's not trained to do time sheet and invoice coding, for now have your bookkeeper track only the three categories that should be easy to break out: subcontractors, materials, and labor. Over time, ask for more sophisticated information (from your field crew as well as your bookkeeper). Perhaps, to get things rolling, have your bookkeeper call the job site at the end of each day to poll the crew on how they spent their time, and then track those actual hours versus the estimated hours. If this extra task runs you a few thousand a year in additional bookkeeping costs, so be it: It's an investment that will pay off many times in the future.

• When estimating a new job, pull the file on a past project that most resembles it (expecting that the file will contain all the accumulated invoices and yard tickets for that job). Try to put together a retroactive job-cost accounting for the past project. Make changes to that report as needed to adjust for the circumstances of the new job, and use the revised report as a basis for the new estimate. For example, say you have a bathroom job coming up and a year ago, you did a nearly identical bathroom. Pull the file for the previous bathroom, reconstruct its job costs, and use it as a basis for the new bathroom estimate.

Fear

Fear-based underestimating is the trickiest ailment to remedy. I have a friend in the industry who chronically underestimated his jobs. Some colleagues and I finally convinced him to raise his estimated margin from 20% to 25% — not enough, but still a move in the right direction. He was so afraid of overcharging, though, that to compensate for the extra margin, he started to routinely reduce his estimated job costs by 5% by finding that much in imaginary "savings."

Fear stems in part from ignorance. If you know your numbers cold, you're less likely to convince yourself that they're too high and pare something off the estimate. But if you're not really sure why you're charging what you're charging, you'll be more inclined to wonder if your price is indeed too high.

Fear-based underestimating comes primarily from those chronic weaknesses so many of us contractors suffer from: need for approval, empathy for the client, doubts about self-worth, fear of rejection, lack of confidence that you can replace this job if you lose it to a lower bidder, and so on — the whole litany of woes. We don't charge enough because we're afraid to charge enough.

Because of how deep-seated it can be, fear-based underestimating often corrects itself only in dramatic ways. One of those is bankruptcy. Another is getting totally fed up, burned out, and

going into another line of work altogether. A third is to struggle and struggle and finally see the light. Peer-review groups like Business Networks (800/525-1009, www.businessnetworks.com) can help contractors see that light: Once you learn what some of your colleagues in the industry are earning, you tend to grow less timid and fearful about what you're charging.

Short of joining a peer-review group, there are other strategies for overcoming fear-based underestimating:

• If you use a spreadsheet to do your estimates, play a trick on yourself. Typically, a spreadsheet estimate will have a cell that uses a simple sum function to subtotal all project costs. That subtotal is then multiplied by a markup percent to yield a gross profit amount, which is then added to the project cost subtotal to yield the sales price. Let's say you're stuck on a 20% gross profit model — that's the most you feel comfortable with. In this example, you'd have a cell that adds all the project costs to generate a subtotal of hard costs. You'd then have a cell that multiplies that subtotal of hard costs by .25 to calculate the 20% gross profit. Finally, you'd have a cell that adds those two cells (the subtotal of hard costs plus the gross profit) to generate the sales price.

Here's the trick: In the subtotal cell, instead of entering a simple sum function, enter a function that both sums the line items *and* multiplies that sum by 1.25 (see chart). Nothing else changes: Keep the cell that adds the 20% gross margin on top of that. The net result is that you're showing yourself a 20% gross margin, which plays to your emotional needs, but in fact you're calculating what works out to a 36% gross margin, which plays to your financial needs.

One more step here: Password-protect the subtotal cell, the gross margin cell, and the sales price cell. Make the password you need to change the cell formulas something like "Risking the financial security of my family by changing the contents of these cells" or, if there's no room for that, make it "Cheatmykids," or whatever hits closest to home.

Sleight-of-Hand Spreadsheet

Standard Spreadsheet

Item	Cost
Drywall	$1,700.00
Finish Materials	$7,400.00
Finish Labor	$11,090.00
Wiring	$6,450.00
Plumbing	$10,438.00
Subtotal	**$37,078.00[1]**
20% Gross Margin	**$44,493.60[2]**

Trick Spreadsheet

Item	Cost
Drywall	$1,700.00
Finish Materials	$7,400.00
Finish Labor	$11,090.00
Wiring	$6,450.00
Plumbing	$10,438.00
Subtotal	**$46,347.50[3]**
20% Gross Margin	**$55,617.00[4]**

(1) Formula: Total Items
(2) Formula: Subtotal x 1.20
(3) Formula: Total Items x 1.25 (cell password-protected)
(4) Formula: Subtotal x 1.20

"Trick" yourself into providing an adequate estimate by integrating a "locked cell" margin formula into a spreadsheet's subtotal cost. This "enhanced" job-cost estimate is then multiplied by a standard markup percentage to give a profitable price for the job.

We don't charge enough because we're afraid to charge enough

• Know your numbers. Have an operating budget and a personal compensation goal and use them to work backwards to what your gross margin needs to be. Understand that any reduction in your gross margin is, in essence, *a reduction in your personal compensation*. Nothing boosts my confidence more when presenting job-cost information than having a good handle on my numbers.

• Get a trusted stakeholder involved: your wife, your bookkeeper, a business coach, anyone who compassionately understands your weakness and wants to help you overcome it. Show that person all your estimates and go through them step by step. Explain what you hope to earn from the job and how. Even if your helper has no way of knowing whether the estimate is accurate, the act of being honest and forthcoming with another person may force you to be more honest with yourself. Set some gross profit goals with your stakeholder, and then report back at the end of each job.

If you recognize yourself as a chronic underestimator, try some of these steps. If you're unwilling or afraid to try any of them, good luck to you — you'll need it.

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