BY RICHARD STEVEN

Flexible Pricing: A Strategy for Uncertain Times

Pricing work has long been an issue for remodelers. I well remember my early days in the 1970s when, with no understanding of operating expenses or profit, I fumbled to justify any charges above direct costs. Only after frustrating business losses drove me to self-education through reading, workshops, and the school of hard knocks did I begin to understand concepts such as burdened labor, gross margin, and the need to make a real profit.

Over the past 30 years, industry educators such as Walt Stoeppelwerth and others have taught business principles to remodelers who essentially found themselves in business by accident as they plied their craft. One such principle was the need for remodelers to price their work at a markup of 1.5 to 1.67 for a gross margin of 33% to 40%.

Many remodeling companies have been built on this principle, and many of them have focused on doing large projects for fixed, non-itemized bids. Their pricing system consists of listing projected direct costs and marking up each item by their chosen multiplier to arrive at a total price. This system has the benefits of being easy to understand and, when costs are estimated accurately, effectively aligning individual job prices with company gross-margin needs. However, there are also drawbacks to this pricing system—especially in a marketplace where proposals are scrutinized with a fine-tooth comb—and some companies using it find themselves struggling today.

One drawback of lump-sum pricing is the difficulty it creates for explaining prices to clients. You may need an overall 33% gross margin, but do your clients see the fairness in marking up the dumpster by 1.5? Should commodities and unique services be marked up equally? To facilitate client communication and to build trust, it may be better to attach a higher markup to demolition and rebuild and a lower markup to the dumpster.

Another drawback of lump-sum pricing is that it starts with a focus on your costs. What if your costs are out of line? What if your direct labor includes fat or your operating expenses include fluff? The marketplace rewards efficiency, especially in competitive times.

HALF-TRUTHS

It's often said that the major reason for lack of company profitability is the failure of remodelers to charge adequate prices, with the clear implication that the solution is a price increase. It is also frequently said that you can't concern yourself with what others are charging; you must base your prices on your costs and charge whatever you need to be profitable. These statements are only half-true. The flip side of prices being too low is that costs may be too high. If that's the case, the solution lies in lowering costs, not raising prices.

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And while it's true that your prices must be set for your specific business costs, we do still need an awareness of what others are charging for similar work. Our business costs do not automatically translate into client benefits. Potential clients compare options, and we must make sure that our higher prices are justifiable by higher value and are not simply the consequence of higher expenses.

GETTING A GREAT DEAL

Flexible pricing is an alternative to lump-sum pricing. Flexible pricing starts with a focus on the clients and the things they value. As consumers, we enjoy buying when we believe we're getting a great deal—not necessarily the cheapest one. When car shopping for our college-bound daughter, we checked the Kelley Blue Book value and prices on Craig's List so we could recognize a great deal when we found it.

What would constitute a "great deal" to your potential clients? Is there any way you can provide it for them? Or can you provide it with only slight modifications? Why are they interested in the project? What are they willing to pay? If your company budget calls for an average gross margin of 30% and the client's project budget is $100,000, what can you provide for $70,000 or less in direct costs?

Flexible pricing might mean explaining what you can do within the client's budget rather than trying to convince them to increase it. It might mean allowing clients to provide more products or services themselves. It might mean applying different markups to different project components.

Flexible pricing does not mean ignoring your costs or basing your prices on what others are charging. Rather, it means focusing first on what clients want and value, then reconciling client desires with your costs. To meet a client's budget, a remodeler I know recently decided not to mark up the roofing portion of a large project. He had used the subcontractor for years and knew the sub would stand behind his work. The remodeler charged six hours of project management at a healthy margin, but passed along the roof itself at his cost. He was delighted to get the four-week job, which had a sufficient gross margin without the roof to pay a month and a half's worth of operating expenses.

Gross-margin dollars are more important than gross-margin percentage. You need a certain number of gross-margin dollars every month to pay operating expenses and generate profit, but the percentage of total sales will vary, depending on that month's volume.

KNOW YOUR NUMBERS

There are definite risks to a flexible pricing strategy. Projects become more complex and project management more difficult. Most crucially, overall company gross margin will decrease unless you offset lower-margined items with increases elsewhere.

If your company budget requires a 30% gross margin, you must achieve that as an average. When individual projects include elements with varying multipliers, the significant margin is the bottom-line total.

Your budget must be based on your average achieved gross margin, not the target margin for your unique services.

NAVIGATING CLIENT UNCERTAINTY

We learned a lot during the Great Recession last decade that might help us with the current moment of uncertainty as building businesses reemerge and prospective clients tread cautiously into spending on new projects. As in the post–Great Recession period, it is likely that homeowners will increasingly pick and choose between vendors and suppliers to put together projects that feel to them like great deals—ones that deliver the highest value for the lowest cost in their own minds.

A flexible pricing strategy can help you offer great deals. The

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trick is to call out your unique services—the type of work that you do better than anyone else does—and treat them differently from commodities—what is easily found elsewhere. The goal is to persuasively justify your prices and the value you provide to the client.

Of course, offering great deals requires that you price with your sharpest pencil. To do this, yet still achieve the margin you need, you must know your numbers. This holds true at any time, but it is especially important in these uncertain times, when, in many markets, the client base may be smaller and the pressure to price jobs competitively that much higher. But even with clients who can afford to move forward with a project, there is likely to be a strong inclination to expect a good deal.

Above all, it's important to question your assumptions. How many gross-margin dollars do you need each month? Are operating expenses as lean as they can reasonably be? Is your target gross margin set correctly in light of actual operating costs and projected volume? Can direct costs be lowered by better project management?

If you are in a bidding environment (as many in the most competitive remodeling markets are), you don't want to become the low bidder. That's not your goal. The goal is to achieve the margins you need by fine-tuning your business for higher performance.

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