ASPIRE

FOR CONTRACTORS

How Contractor Profits Are Actually Generated

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HOW CONTRACTOR PROFITS ARE ACTUALLY GENERATED

How do contractors make money? This might seem like a silly question. Everyone knows that all you need to do is keep costs and overhead less than revenue. Well, yes – but. That's like saying that in order to lose weight you just need to burn more calories than you take in. While true, it doesn't answer the question: how do I lose weight? The processes and knowledge required to reach and hold a goal can be very different at certain ages, with different metabolisms, different start points, and sometimes with different physical and emotional weaknesses or disciplines. And so it is with reaching profit goals for contractors as well.

To reliably lose weight and keep it off, new knowledge is required, major lifestyle changes are usually required, and outside help is often needed. A trainer, a dietitian or a health club membership could be part of the answer for some people. No single-approach program will work for everyone who wants to get in shape and remain in shape. Using the right program is vital to achieving the goal.

Contractors too need a plan, knowledge, and business discipline to make meaningful and lasting changes to their bottom line. Growing a small business is not a linear process but a step-function process. You have already experienced this. In the very beginning, your business probably operated differently than it does today. More than just increasing your revenues, you found new methods and behaviors were required at various levels of growth.

If your current goal is to substantially increase your profits and to better handle the Boom and Bust cycles, then you must realize that "what got you here will not get you there!" Trying to reach your dreams by simply doing more jobs, getting more revenue, and doing what you already do a bit better is unlikely to achieve that goal. You will achieve your dreams by doing things differently than how you do them now. That is also true about knowledge; it's not about accumulating more knowledge about how things have always been done. It's about different knowledge – new learnings followed by new ways. For more information on construction Boom/Bust cycles, check out our Beating the Boom and Bust Cycles report, available for free on our website.

Before we can fully understand how contractor profits are actually generated, we need to discuss some business concepts.

LEVEL 1 AND LEVEL 2 MANAGEMENT

Level 1 and Level 2 management are also called Management from the Inside Out and Management from the Outside In, respectively.

Level 1 management is the way an industry traditionally does its business. Every vertical market has beliefs and approaches to marketing, planning, compensation planning, and pricing strategies that are accepted as the defacto methods for doing business. Often these practices are sub-optimal, sometimes just plain wrong. Some practices that used to be the best ways are no longer the best, yet they are still practiced. Level 1 practices are the things you learned on the job, from previous employers or family, in articles written by experts from within the industry, in classes, and from business coaches who have spent their lives practicing or learning the way it's always been done. Level 1 management practices are critical to your success. It just isn't possible to run a contracting business without strong Level 1 knowledge. The majority of that knowledge is useful, however, the parts that are weak, wrong, or outdated are extremely costly in profit loss and cause unnecessarily heavy workloads and uncomfortable stress levels.

Level 2 management methods are generally not practiced, taught or understood within small contracting businesses (under $20M in revenues). Level 2 practices are more advanced management tools. Level 2 practices are effectively applied every day in all larger businesses; at The Bechtel Group, at Google, at BMW, and at Starbucks. Level 2 methods are heavily studied, constantly upgraded, and constantly modified in response to economic, cultural, and technological changes.

At Aspire, we don't want you to behave like a big business; burdened by policies and formality, slow-moving and impersonal. Contractors under $20 million in revenue annually have great advantages over the big guys, as well as a higher degree of personal satisfaction available to ownership. Chief among these advantages are nimbleness, micro-market marketing, and personal relationships with clients (we know that there are certain days where this last one might not be on your list of good things). The effective balance for small and mid-sized contractors is to strengthen and celebrate their smaller-company attributes while concurrently introducing the right-fitting Level 2 techniques to move their business forward.

There are methods, tools, techniques, and strategies in Level 2 business management that are so strong that they will provide a small contractor with a powerful competitive advantage. This set of Level 2 practices allows the contractor to retain all the advantages available to a small business yet implement some great tools for reducing workload and increasing control, while enjoying a significantly stronger bottom-line lift.

Ever have the feeling that there must be more in the way of business tools than what you know? Has the concept of "taking your business to the next level" been elusive despite your desires and efforts? The limitations of a Level-1-only management approach are the reason. Let's fix it. This report is designed to offer some modified Level 1 techniques and introduce you to some Level 2 techniques that will make a significant difference in your life. Part of the answer to where contractor profits really come from will be found with the application of some Level 2 practices.

BUSINESS MODELS

To understand better how contractor profits are generated, and more importantly, to understand how to increase bottom-line results, a contractor must first understand the role of the business model.

The word "model" may suggest a complex process that involves unfamiliar concepts and a whiteboard filled with complex mathematical formulae. Happily, though, business model optimization is straightforward and accessible. Every business has a business model, even if the owner has never thought about it once. The important question is whether or not a specific business model, if executed reasonably well, will deliver the contractor's business and personal goals. At Aspire we find in our work with contractors that, most of the time the business model of the contractor will not deliver their goals, even if executed to perfection. This leaves the contractor with three possible paths. One path is to just keep whacking away at it without reward, blaming it on the economy or today's lazy workers and hoping things will somehow change. A second path would be to recognize and accept the fact that they won't reach their goals. The third path is to change their business model.

A business model, at its most basic, is a blueprint describing how the pieces of the contractor's business fit together to achieve a defined objective. One GC may provide services through insurance companies to restore homes damaged by smoke, fire, or flood. Another may specialize in high-end kitchen and bath remodel, while another may try to find their niche with low prices. A GC may have their own in-house team for design, framing, drywall, and painting, while another may use subs almost entirely. All are contractors in the construction industry, but each has a different business model. Ultimately, the business model answers these questions: Who is your customer? What does the customer value that you are prepared to deliver? How do you differentiate your business from the competition? How do you find and retain the right customers? How do you deliver that value with profit left over for you?

A business model has two primary parts. One part is the numbers – will the business be able to charge more than the project's costs and overhead to deliver the contractor's dreams? The other part is the story. A business model should be able to be translated into a compelling story of how your business works. The business owner will prosper who pays attention to that story and continues to make it a better story, rather than just dealing with the opportunities and projects thrown at them. Every successful organization has a sound business model as its foundation, even if the model was created by accident.

Business models designed proactively with knowledge and forethought have embedded within them the power to minimize the negative impact of the Bust cycles as well as to get the maximum benefit from the Boom cycles while maintaining a healthy cash flow and workload. Business models that evolve reactively, without clear direction from management, will not only absorb the full negative impact of these economic cycles, but will actually magnify that impact.

Differentiation

Every business model provides the foundation for a business strategy and that strategy is part of the business model's story. In contracting all successful strategies will feature an effective differentiation strategy.

There are really only two strategies for all businesses: differentiating the business or being a low-cost leader. Starbucks is more expensive than other sources of coffee and food, but it offers a specific experience delivered reliably. A Ford and a BMW are both cars that will get you where you are going, but the BMW costs much more. A good-sized segment of every market is willing to pay more for a better, faster, cleaner, safer, more convenient, or more enjoyable experience. Contractors must address this market segment if they wish to find superior profits.

To win with low or competitive pricing, the contractor must drive volume. To make this strategy work, the contractor must have what is called “infinite capacity” – meaning they can grow rapidly without substantial barriers (funding, management) while implementing multiple management levels as they grow. Small contractors are a poor fit for developing the systems, funding and plans to become huge. Employing a low-price strategy AND remaining small (under $20 million) is a business strategy that will ensure that the contractor will work too hard, for too long, for too little.

Business Model Summary

A small contractor cannot win on price and volume. A winning business model for a small contractor must be built on generating the highest-possible return on its assets (knowledge and people mostly), rather than relying on the rapid build of assets. Simply put: maximize profit on fewer projects with a small, nimble team.

HOW CONTRACTORS ARE MAKING THE PURSUIT OF PROFIT HARDER

PRICING STRATEGY

The chances are quite high that your pricing strategy/method is wrong. We realize that is a bold and somewhat aggressive statement to make, but that has been our experience over the decades. Contractors are applying a pricing strategy that fits retail commodities but is not a fit for complex, service-oriented businesses like contracting. This mistake in pricing strategy will always put severe limits on profit long before a contractor’s goals are met.

Whether fixed-bid, cost-plus, or time-and-materials, most contractors apply a fixed markup as the method for determining job price. In most fixed-bid jobs, the common approach is to add 20% to the total job cost; 10% to cover overhead, and 10% for profit. Cost-plus is usually tagged at 10% to 15% above cost. However, the outcome is that, averaged over time, the contractor almost never takes a legitimate 10% to the bottom line.

A markup-driven pricing strategy creates another significant problem; it leaves the contractor with only one avenue to raise profits. That avenue is often the most difficult, risky, and stressful of the possible routes to the goal. Using a standard markup applied to total job costs only leaves the option of increasing the number of projects won and/or increasing revenue to lift their bottom line. There are other ways to increase profits that are far more appealing, but they become invisible when the contractor only knows and uses a fixed-markup strategy for pricing.

There is a pricing strategy called Value-Based Pricing (VBP) in which the price of a project is based on the value delivered, rather than only the sum of labor, materials, subs, overhead, and profit. VBP is the correct pricing strategy for complex, service-oriented providers – like us. VBP provides the pricing system that allows for conversion of a contractor’s differentiation into revenue and profit. A variation of VBP is called Premium Value-Based Pricing (PVBP). For many contractors, a PVBP strategy works very well as part of a positioning strategy to be an elite provider in the industry. PVBP offers the best profit-per-dollar ratio in the business!

MARKUP VS. MARGIN BUSINESS THINKING

In our industry there is a lot of debate and even more confusion and misunderstanding regarding Markup vs. Margins. Some of the confusion starts from the idea that they are two ways to get to the same result. This isn't correct.

Markup is the percentage difference between actual job costs and the selling price.
Margin is the percentage difference between the selling price and the Gross Profit goal.

Markup is math. Margin management is a business strategy.

Markup is usually applied consistently regardless of cost category or job characteristics. A Margin-based strategy controls the markup on each cost grouping; labor, subs, materials, design, and change orders to achieve the desired profitability.

Markup determines price. Margin controls profit.

Use of a fixed-markup pricing strategy explains why contractors only average about a third of the profit that the markup was intended to generate, even in good business times. Averaged over a complete economic cycle (from Boom to Bust and back to Boom), contractors only average about 15% of the intended profit, based on the markup-strategy math.

A 20% markup does not generate a 20% margin, it generates a 16.7% margin.

All larger or professionally managed businesses run on a margin-driven business strategy; that is, all pricing and markups are determined by achieving a margin target. Smaller businesses, particularly if they are a service business (vs product or commodity), will be much more prosperous if they adopt a margin-driven strategy. There is no benefit or business rationale for a fixed markup except for the lack of knowledge needed to do it the right way.

How To Implement A Margin-Driven Business Strategy

This fundamental change in contractor pricing begins by establishing a Gross Profit Dollars (GPD) target. Let's say a contractor needs/wants to generate an increase in cash flow by $150K to support the cost of someone to do estimates, give some pay increases, build a fresh, high-quality website and collateral material package, and give themselves a $50K-per-year raise. Further, let's assume this contractor is currently generating GPD of $300K per year. Therefore, the GPD generated needs to be lifted from $300K to $450K. The beginning of changing from a revenue and fixed-markup model to a margin-driven model is to establish the GPD goal, in this case: $450K. Business model changes and the embedded business strategies must be designed to achieve this GPD goal. It's about doing "business on purpose" rather than taking a reactive approach. The reactive approach is "Let's just do as many jobs as we can and see how it works out."

The three important things covered so far work together as a profit-lifting team:

1. The right business model to achieve the GPD goal
2. Competitive differentiation embedded in the model
3. Margin control and management.

These three work together to allow you to win jobs more easily, charge more fairly for your value and achieve the GPD target. We will introduce another strategy in the next section that allows you to increase your profits without trimming expenses, reducing costs, growing sales, or increasing prices!

Basically, the strategies introduced so far combine to support an 8 to 10% cost premium over competitive pricing levels in your market. Differentiation is the key to justifying premium pricing. To learn more about how to effectively differentiate your business in your market, please consider attending one of our one-day workshops in your area. Visit www.theaspireinstitute.com for more information about workshop dates and locations.

Implementing a Premium Value-Based Pricing approach is simple enough, but must be linked to delivering higher perceived value that will be important to a sufficiently large segment of your target market. For some contractors creating and delivering this value is simply a matter of repackaging and repositioning what you already do. For others it may be a long journey.

Setting Price Based on Margin Targets

In a margin-driven pricing strategy, proper pricing for a contractor will be based on a pricing matrix (or matrices if they have multiple profit centers, like custom homes and remodeling). A sample pricing matrix is illustrated in the chart below. Please note that this is not a real contractor, and the numbers are not necessarily the right numbers for your business.

Contractor Pricing Matrix
for Nifty Remodeling, Inc.

Cost Group	Margin Target	Markup
Company Labor	45%	1.82
Materials	30%	1.43
Subcontractors	25%	1.33
Change Orders	50%	2.00

Why break pricing down into job-cost groups? Why have different margin targets for different cost groups? The reason is that this allows the contractor to control margins to meet profit targets.

Let's use labor costs to further amplify the reasons, differences, and results of this change in pricing strategy. Perhaps as a general contractor you have a large in-house labor crew. You do your own design, framing, painting, and plumbing. Your theory is to retain the profit margin that would have gone to subs and to increase control and quality. Your sister is a GC in the next town over. Her model is to minimize in-house labor and sub everything. You each win a $400K whole-home remodeling job.

In the course of your job, your crew makes 19 unplanned (and un-estimated) Home Depot runs, and there was little or no production on 13 project days due to weather, equipment breakdowns, permit issues, and homeowner issues. Perhaps you pay some overtime to catch up. You've accounted for some of this in the estimating process but never all of it. So, you have increased labor costs due to productivity issues, and you had to pay your people on low- or no-production days. If your sister's job has the same productivity problems, did she have to spend more? In this situation, her costs remain fixed, and yours grow. This is not to suggest either strategy is the best one for you, they both have their merits and fit certain goals and situations. It is to suggest that if you both did the same total cost markup, but you leaked margin and therefore bottom-line profit where she did not. These are among the reasons that in-house labor requires a higher margin (and therefore markup) than do subcontractor or materials costs. The balance of in-house labor to subs shifts over time. Therefore, in-house labor, subs, material, and change orders each need their own margin target to ensure the overall margin and GPD goal are attained.

Change orders kill productivity. Not just on that job but on other jobs from which you had to pull workers to deal with the change. Change orders must have a different margin target to cover the productivity dilution.

Materials are more stable, but there can be issues there too. Six trips to the neighboring state to select or pick up the right materials or to manage the cutting of just the right granite for a project certainly have more cost than a job using materials from Home Depot. Contractors who do historical restoration need a different margin target for materials than a contractor throwing up a garage, due to the time the contractor spends on finding or customizing the right materials and dealing with the client.

Getting Paid For Your Value

Simple fact: You are worth more than you have been paid. Perhaps only medical services have greater importance and a more lasting impact to a family (or business). You do real, important work. You create beauty and balance. You build things that last. Surely you deserve to out-earn several other professions that usually out-earn you. Shall we include attorneys and politicians on that list?

Business model optimization and margin management are not about charging more. Business model optimization and margin management are about tuning your business so that your services are worth more!

Charging more than your competitors must be based on delivering a greater value to your client than your competitors. The marketing and sales processes must prove this greater value, not just say it.

Competitive pricing doesn't work. The average contractor, when measured over a complete economic cycle (Boom to Bust to Boom again), averages about 2% Net Operating Profit (bottom line). You can't achieve your dreams at 2% Net Operating Profit, so you can't play the same game as your competitors. You have to change the playing field. To win at the strategy of maximizing your return on assets, you must consistently charge and deliver more than the competition. You won't achieve your dreams with simply more revenue. Nobody does. Superior margins are required.

Charging properly, that is, using a properly designed pricing matrix and setting your business apart with a strong differentiation position will support an 8% to 10% pricing premium over "competitive pricing".

The chart below compares two models that each generate the same 12-month Gross Profit Dollar outcome of $380,000. This GPD outcome will generate the same bottom line (Net Operating Profit) and create the same market valuation for the business.

Model 1 reflects the revenue-driven approach with the fixed-markup pricing required to achieve the $380K GPD target. In this example, the operating margin (not reporting margin) is 10%. Therefore, a $3.8 million revenue level would be needed to achieve a $380K GPD. This model requires 76 jobs to be completed at the baseline average of $50K average per job.

Model 2 also generates the target $380 GPD but does so through an optimized business model that generates an operating margin of 28%. In this example, raising revenue is not the goal, but average revenue will go up slightly due to the business model optimization. The bottom-line impact doesn't come from the revenue lift but from the business model adjustments, including changes in pricing, job mix (explained in the next section), change-order management, and other business model changes. With this approach only half of the revenue and one-third the number of jobs, are required to achieve exactly the same profitability outcome!

Clearly, Model 2 is a much better way to achieve the $380K GPD goal, yet most contractors align their strategies and efforts around Model 1. This grows primarily from the pricing strategy in which markup is fixed, robbing the contractor of attractive and powerful margin-increasing techniques.

Two Models - Same Revenue - Different Profit	
Model 1	Model 2
• $3.80M in revenue • 76 jobs per year • $50K per job • 10% AGM • $380K in Gross Profit	• $1.35M in revenue • 23 jobs per year • $58.7K per job • 28% AGM • $380K in Gross Profit
Both Models Give You A Quarter Million Dollar Income	

THE LITTLE-KNOWN OPPORTUNITY FOR PROFIT LIFT: OPTIMIZING JOB MIX

Ready for a challenge? How can we increase profit without raising the price, lowering cost, or reducing overhead while revenue and workload are substantially reduced? Hint: No real magic is required.

Job types, or job groups, have different profit profiles. If contractors took a quiz where they were to select which of the following job types and job characteristics would be more profitable on average, mostly all of their answers would be the same.

1. Multiple-bid jobs vs. referrals from previous clients?
2. Any job at any price vs. job types that are the contractor's specialty?
3. Jobs within 10 miles of your location vs. far-away jobs?

There are several more job characteristics that impact profitability. Contractors can learn how to manage their job mix rather than just take whatever leads, referrals, or jobs that they win. The important thing is that the margin gap can be so broad between best- and worst-margin jobs that even a small shift in the mix of work can have a significant impact on profitability.

As you watch television, pay attention to the car commercials. You will notice that pickups, SUVs, and top-of-the-line cars are promoted more than the lowest-priced models – by far. That is because those pickups, SUVs, and top-of-the-line cars generate much better margins than inexpensive vehicles. Higher-end models allow more opportunity for differentiation, which in turn allows for greater price elasticity. Higher-end models are purchased by people with more disposable income who are willing to pay for intangibles, allowing the manufacturer to get higher prices without higher costs. This makes business sense and results in greater profits. This works the same way for contractors. Here is a chart comparing two job-mix models:

JOB MIX COMPARISON
First model - unmanaged job mix
10 jobs completed with an average job size of $100K generating an annual revenue of $1,000,000. *Average Gross Margin over these jobs is at 15%, generating $150,000 in GPD.*
Better model - job mix optimized for job size and margin
6 jobs completed with an average job size of $120K generating an annual revenue of $720,000 *Average Gross Margin over these jobs is at 24%, generating $172,800 in GPD*

The job-mix-optimized model generates more profit with a substantially lower workload. That workload can then be redirected to other profit-increasing activities.

REPORT SUMMARY

Beyond the methods to lift profit covered here, there are plenty of other opportunities to raise profits that are rarely practiced by contractors. Plugging profit leaks, including change order management, contract deficiencies, estimating mistakes, and not using Professional Service Agreements (PSAs) to charge for design work are just a few examples. These kinds of profit leaks usually get bigger when revenue is driven up, resulting in more revenue at a lower margin for less or possibly even a loss of profit after what appears to be a successful revenue-building campaign.

A simple mistake in bookkeeping, such as a chart of accounts misstep, can represent a lot of profit lost every year. For example, let’s say that ownership is made up of two partners who each take a $100K-per-year salary. The total of the salaries is coded as a fixed cost. However, perhaps 70% of one owner’s time is in selling, estimating, and project supervision. 50% of the other owner’s time is in project supervision. That means $120,000 of labor costs did not show up in the labor costs and therefore did not get marked up in the estimating/pricing process. The margin alone on that lost job cost is about $25K.

So, where does contractor profit really come from?

Not from generating revenue, then more revenue, and then more revenue after that until your profit goal is reached. Perhaps you have noticed that by revenue alone, you never reach your profit targets. And you have to work much too hard!

The key number that connects most directly with profit is Gross Profit Dollars.

Assume a contractor raises revenue by $100K over the previous year. Most often, campaigns to lift revenue will actually reduce margins in the process (aggressive pricing, more sales costs), thereby diluting or defeating the goal of more profit for the owner. Let's assume, however that this contractor is extra smart and can figure out how to grow the revenue without diluting their operating margin of 17%. How much of the $100K in incremental revenue gain falls to the bottom line? Assuming the revenue campaign did not cause an increase in fixed costs, then exactly 17% or $17,000 of the $100K falls to the bottom line and into your pocket.

Alternatively, this contractor could employ a margin-driven campaign and increase margins such that the Gross Profit Dollars increase by that same $100K. How much of the incremental GPD falls to the bottom line? *All of it.* The full $100,000 is retained by the owner every year.

$17K profit lift or $100K profit lift? Easy choice. Almost no contractor carries an average gross margin in the best-practices range; therefore, there is almost always room to expand margins. So, business model changes to optimize job-mix changes in parallel with creating or strengthening your competitive differentiation is the pathway that works, not driving to win more jobs and generate more revenue. The pathway is: first, fix your margins; then, from this solid margin platform, layer on more revenue. Doing it the other way around hasn't really worked that well for you or other contractors yet.

This is the answer to the question: where do contractor profits really come from?

Important Note: This report has shown how profits are actually generated in the contracting business. It has not shown HOW to accomplish these business model changes and plug the profit leaks.

If you'd like to learn the HOW part, visit www.theaspireinstitute.com, email us at info@theaspireinstitute.com or call at 888.252.8998.