

Price wars not the answer for contractors in a sluggish economy

Unlike many businesses, a contractor's revenue can fluctuate wildly. The old expression "a contractor is only as good as his last contract" might be an oversimplification, but is not far from the truth.



PROFIT MARGINS

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Current economic conditions have many contractors facing significant declines in revenue, and some are losing money for the first time in years. In an attempt to maintain current sales, too many contractors are bidding jobs with low gross profit or no gross profit. This is a dangerous reaction to a difficult situation.

Contractors face pricing challenges for several reasons. Each contract is unique and must be priced separately. Also, there is sometimes a significant delay between the date a contract is awarded and the date it commences. These factors increase the risk that a contractor might not price a job effectively.

The first step in the pricing decision should be assessing how much it will cost to complete the contract at the level of quality demanded by the customer and acceptable to the contractor.

Obviously, any discussion about gross profit assumes a contract price that covers all direct and indirect costs.

How much return should the owner expect on that investment? Considering the risk associated with owning a construction company, it is reasonable to expect a return of 25 to 40 percent of the invested capital.

Once a contractor has determined total overhead and bottom line profit, the next step is

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to forecast how much volume the company can obtain and successfully complete with the current overhead.

Normal gross profit can then be calculated by dividing the forecasted revenues by the total overhead and profit.

Of course, nothing is that simple and the contractor should use this calculated figure as a starting point.

There are other factors to be considered in establishing a normal gross profit: How much risk is involved in the contract? What will the market bear? How specialized is the service? Is the company's overhead reasonable?

What about bidding jobs below normal gross profit in a down economy? A contractor might reduce the bid on a job based on a history of receiving profitable change orders with that customer. Contractors also might

accept a reduced gross profit on a high-profile job to use the job to market their services. Finally, in a temporary slowdown, it may make sense to get some jobs to keep key employees busy and cover some overhead costs.

It is important that the contractor maintains the capacity to take on more profitable jobs as the opportunities arise. Jobs taken below normal gross profit should be in the contractor's area of expertise with low risk for good owners.

Too often contractors get nervous in lean times and bid recklessly to maintain volume. This might seem like a good idea but can prove deadly in the long term.

A contractor needs to maintain some price integrity. Any contract demands that a contractor take on a certain amount of risk and exercise a level of skill in completing it, and contractors deserve to be compensated for the effort.

Contractors cannot change the current economic environment, they can only control their response to it. They must stay out of pricing wars.

Good contractors will be proactive and use the challenge of the sagging economy to make adjustments to things within their control.

This will not only help the contractor weather this storm, but will also position them for greater success when markets improve.

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