Job Pricing For Slow Times

by Richard Harshaw
Lodestar Consulting Systems, Inc.

It is the slow time of year. There aren't enough jobs to go around for all the contractors in the area, and you have crews to keep employed. If you lay them off because of a lack of work, they might end up working for a competitor who has work to do right now—even if that work was bid at a "loss." What to do?

The answer to this dilemma comes from the manufacturing world and may surprise you!

Seasonal Pricing– it Works!

In the past, when a contractor was in his slow season, he often would take jobs at what would normally be ridiculously low prices "to keep the crews busy" so they did not quit and go to work elsewhere. There was no scientific way to know when or how to do this. Manufacturing theory gives us the tools to deal with this safely.

Manufacturing theory says that when a plant is running at peak capacity (in our trade, this usually means the summer season), pricing should rise *above* normal levels. The reason is simple: the market demand is there, and all producers are running full tilt, so no one has idle capacity. For you, this means that if you would normally sell a 3-ton condensing unit for $2,400, you might sell it for $2,500 or even $2,600 in the peak of the summer rush.

This theory also says that when you are not at peak capacity (what I'll call "the doldrums"), ***any price you set above your direct costs and variable costs will help the business.***

Did you catch the full impact of that?

This means that during the doldrums, you could take a job for a lot less than you normally would and still be okay. As an example, the 3-ton condensing unit we just considered might sell for $2,000 during the doldrums.

How can a contractor do this and stay healthy? By understanding the seasonal nature of this business and his production cycles.

Overhead is the key.

About 85% of the overhead of most contractors is fixed— it does not vary from month to month. The other 15% fluctuates with sales.

Take a contractor with overhead of $250,000. Of this, about $212,000 would be fixed and $38,000 would be variable. On average, this means about $17,700 per month for fixed overhead. That's $17,700 per month in the peak season, as well as $17,700 per month in the lull.

During the doldrums, we often fail to get enough work to even break even. After all the bills are paid during the doldrums, there may be only $8,000 or $10,000 left to apply to overhead, leaving us far short of covering the overhead for that month. We must fund

the shortage out of our built-up reserves of cash from the summer season— "living off our fat", like bears in the winter!

Now consider what happens during the doldrums when a contractor who understands overhead and production cycles encounters a job. Suppose the job's total costs come to $18,000. Normally, he'd price the job at $22,000, but because it's the doldrums, he knows that every "low ball" bidder out there will be fighting for this job. It might bid as low as $19,000. Should he go for it too?

At first glance, he'd be nuts! Leave $3,000 on the table? No way!

But hold on! That overhead lug of $14,500 is back there just waiting to pounce on the checking account! The contractor could dig in and say, "Nope, I'm not going to try to take that job at $19,000!" In which case, he pays all the overhead shortfall out of his company's built-up reserves without any job money at all to help. Or he could say, "Well, I don't like it, but it's better than nothing, because it will give me $1,000 of the customer's money to apply to the overhead this month, and that's $1,000 less that has to come out of the company's coffers."

Did you notice that? If he takes that job for $19,000, he surely doesn't make his normal profit— in fact, he makes a loss on it. But he makes less of a loss than if he did not get the job at all, where *all* the overhead comes out of *his* pocket that month.

At the end of the year, the $1,000 that he applied to the slow month's overhead shows up as an extra $1,000 of profit. Is *that* a stupid move?

But what are the limits?

The problem is that most contractors don't know what the limits are for this theory of job pricing.

The first requirement to successfully couple production cycles to job pricing is to ***know when your doldrums occur***. A slow month is any month where your labor sales will probably come in at less than 85% of full capacity. If you have 6 installers, let's say, each could work 22 days a month (on average). At 8 hours a day, the theoretical labor pool would be 6 men x 22 days x 8 hours a day, or 1,056 hours. Deduct 15% for a typical company's unapplied time, and we're down to 900 sellable hours. Allow another 15% of the 900 hours for a "cushion" for those special jobs that come along or for unexpected job snags. This takes us down to 765 hours.

Any month where we see we're going to sell fewer than 765 installer hours qualifies as a slow month. I have at least 135 hours of unsold labor (not counting a 135-hour "hot job" reserve), and if I don't sell it this month, it is gone!

This requires, of course, that you have an ongoing job tracking and backlog system. ***You must track backlogs, and you must forecast labor use at least four months out.***

Second, you must make sure that the job you are bidding **will be done entirely with doldrums hours** (in our example, using some of those 135 unsold hours). For short jobs (like residential replacements) this should be a no brainer, but what about commercial jobs?

This is much trickier. Too often, we'll bid commercial jobs and get them only to

discover that the start date gets pushed back. If this happens in the doldrums and we bid the job with slow month pricing in mind, it may push the job into our busy season. Then we're hurt, because we have committed precious labor to a job that is priced too low for full capacity times.

So here comes the second technique for using lull pricing. ***If the job may spill out of the doldrums and into the busy season, price the job by figuring what you would normally sell it for and then set a doldrums price. Figure what percentage of the job will be done during the lull and apply that percentage to the lull price. Take the balance of the job completion percentage and apply it to the busy season price. Add the results and bid the job at that.***

Here's an **example**. A job would normally bid for $37,000 in the busy season, but we set a slow time price of $29,000. The job will probably be 2/3 done during the lull, and 1/3 in the busy season. Our bid price should be 2/3 of $29,000 ($19,300) plus 1/3 of $37,000 ($12,300), for a total bid of $31,600.

Catch the Hidden Costs!

We must also be sure that we cover our variable costs. This is involved, but not difficult to do.

A contractor's P&L shows that against the variable costs of $40,500, he ran direct costs of $522,500. In other words, on average, his variable costs run about 7.8% of direct costs.

Knowing that, he can now **compute a factor for variable costs**. With job costs, say, of $16,000, this means he needs to add 7.8%, or $1,248 for variable costs.

Almost done, except for one item. Most P&Ls list the interest expense "below" the line. That is, the accountant shows it as an expense after the net profit from operations is reported. If that is the case for your P&L, you need to figure out ***what percentage of your direct costs interest expenses are and add that to your job costs too.***

For instance, if our interest expense (below the line) is $9,000 a year, interest as a percentage of direct costs runs 1.7%. We would need to allow then about $270 (1.% of $16,000) for interest expenses. Our total job costs now come to $16,000 + $1,248 + $270 or $17,518. Any price over this in the doldrums would help.

Important note: if your P&L has the interest expense listed as part of the variable expenses, you don't need to do this last step because interest will be recovered in the variable cost calculation.

Don't Overlook the Loans!

One final technicality—you must do jobs in such a way that you can **support your business's cash flow requirements.** There is one item we have yet to cover, and that is the portion of long-term debt that is coming due this year. In other words, **how much of the loan *principals* must be repaid this year?** This figure does not show up on the income statement. It shows up on the balance sheet, because you are paying back the bank's own money when you repay the principal. The interest ***is*** your money, and you record it on your income statement. But not the principal.

A contractor must assign a portion of current notes payable to the installation division. The easiest way is to use the percent-

age of sales. For instance, if a contractor has $18,000 in notes payable this year, and residential installations make up 60% of his business, we could say that about 60% of this, or about $10,800, is the obligation of residential installation. This may not be exactly the case, but it is close enough.

We must then figure out what portion of the cost of sales this $10,800 is and apply that percentage to a job's costs to allow for the cash flow requirements of the loan principal this job must carry.

What can we conclude?

That production cycles, when coupled with dual factor pricing methods (COWL), give us the tools for maximizing production, revenue streams, and capacity year round if we stay on top of our businesses and the market and know when we are entering a lull— and price our jobs over our costs during that time.

Your production will rise (but not dangerously so) and your business will run at higher capacity year round. Like the engine of a fine car, it will purr!

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