



The Mistake of Markup

by Sal Alfano

I recently attended a business seminar in which a roomful of builders discussed various ways to “mark up” direct costs to arrive at a selling price. The seminar speaker explained that he uses a *divisor* to arrive at his selling price. For example, take a job where the total estimated direct cost (material, labor, and subcontractors) is, say, \$10,000. To add an additional 20% gross profit, this builder divides by .8. The selling price would then be \$12,500 ($\$10,000 \div .8$).

A number of builders in the room spoke up, saying that this was the same as multiplying by 1.2. At first glance, this makes sense: Multiplying by 1.2 marks up costs by 20%, right? Wrong. Multiplying by 1.2 is *not* the same as dividing by .8.

In the ensuing debate, it was obvious that about half the people in the room were calculating the selling price for estimates in a way that guaranteed they would lose money on every job. In the sample estimate mentioned above, multiplying \$10,000 in direct costs by 1.2 yields a selling price of \$12,000 — \$500 less than the method that uses a divisor. On larger jobs, the difference is greater: If direct costs are \$100,000, the two selling prices are \$5,000 apart; on a \$500,000 job, the difference is \$25,000. Builders can't afford to throw away that kind of money. What's going on here?

Gross Profit, Not Markup

The term “markup” is responsible for some of the confusion. In fact, most of us are familiar with markup because of its opposite — “markdown.” When an item in a retail store is on sale, it is usually marked down a certain percentage. To arrive at the “sale” price, shoppers simply *multiply* the tagged price by the percentage, and subtract. For example, when an item normally selling for \$100 is marked down 10%, it sells for \$90.

It's a mistake, however, to assume that markup is simply the reverse of markdown. To get our \$90 on-sale item

back up to list price, we cannot simply add 10%. If we do, we get \$99, not \$100. Yet this is exactly what many builders do when tallying estimates.

Forget markup. If you want to consistently price your jobs to cover all of your expenses, abandon the concept of markup and start thinking in terms of *gross profit*. Gross profit is a dollar amount equal to the sum of *overhead plus profit*.

Overhead for a small construction company typically includes the salaries of the owner and any office help, plus all the costs of running the business that are not directly related to construction. These costs include office rent and utilities, office supplies, insurance, and vehicle expenses, among others.

Profit is the amount of money earned after all expenses — both direct costs and overhead — have been paid. Profit is not simply the amount of money left over at the end of the year — it's a specific dollar amount representing, among other things, the return on your capital investment, as well as compensation for the risks you take in your business. Ideally, profit should be 10% of total sales, but many construction companies earn closer to 5%.

If you don't know what your overhead and profit amounts are, use last year's records to find out. A simplified schedule of overhead and profit for a typical small construction company (\$250,000 in total sales) is shown in the table below.

Gross profit percentage. One of your business goals should be to earn the required gross profit on every job. To do this, however, you can't just divide the total dollar amount of gross profit by the number of jobs, and add the result to direct costs. If you did, you'd overbid small jobs and lose your shirt on big jobs.

The easiest and safest way to include gross profit in every estimate is

to convert gross profit dollars into a percentage. To do this, divide gross profit by total sales:

$$\frac{\$49,000 \text{ Gross Profit}}{\$250,000 \text{ Total Sales}} = 19.6\% \text{ Gross Profit}$$

You'll need to estimate what your total sales will be for the year (see *Business Forum*, 10/94), but this number usually doesn't fluctuate much. If you did \$250,000 worth of work last year, you'll probably do at least that much work this year. If you anticipate more or less work, recalculate the gross profit percentage based on a higher or lower sales figure.

Find the Selling Price

Once you know the direct costs of a job and the gross profit percentage you need to earn, it's easy to come up with the selling price. First, subtract the decimal value of the gross profit percentage from 1:

$$1 - .196 = .804$$

Now use this divisor to figure the correct selling price:

$$\frac{\$201,000}{.804} = \$250,000 \text{ Selling Price}$$

You can do everything right when preparing an estimate — take off materials down to the last stud, plug in firm quotes from subs, and figure labor costs to the man-hour. But if you use the wrong formula to cover gross profit, you'll lose money every time. To avoid this costly mistake, make one simple change in your process — using a divisor instead of a multiplier — and cover all your costs on every job. ■

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