BY DAVID GERSTEL

The Why of Profit?

David Gerstel began his career in construction as a framing carpenter, has been a general contractor for four decades, and is the author of several books on construction company management.

"Jake," as I will call him here, is a skilled carpenter and project manager. His work is tight. He's reliable. He doesn't make excuses for mistakes. He just fixes them. As a result, since he got his general contractor's license and went on his own a couple of years ago, Jake has worked steadily on the basis of referrals from his customers.

When Jake finishes a job, he's likely to happily announce, "I made a good profit on that one." Usually, he's mistaken, for several reasons. He's misled by his healthy-looking bank balance. He fails to note that a good chunk of it is not from his supposedly profitable jobs but from a deposit for a new job—one barely underway and for which no balance-reducing bills have yet been paid. In other words, Jake falls prey to the hazards of cash accounting.

While he does track every dollar taken in, Jake is ignoring or understating his expenses. When calculating what he calls "profit," he adds up all payments received from his clients. But he subtracts only the cash he has laid out for materials and subs at his projects. He ignores all the costs of doing business beyond the direct costs of construction out in the field. Like a lot of startup builders, he thinks he doesn't have any such overhead costs—aka SGA (sales, general, and administrative) expenses—worth mentioning.

In fact, his SGA responsibilities burden him with significant out-of-pocket costs—for innumerable items from paper clips through his office computer—and for a huge amount of time. For every hour he spends on his jobsites, Jake spends roughly another half hour at SGA tasks like these: Phone conversations and visits with prospective clients. Completion of specifications for plans from designers. Estimating. Keeping the books. Building a network of trade partners and suppliers.

The value of those hours is not included in his calculations. If he did figure them in, he would arrive at a much less rosy conclusion about "profit" he is hauling in. To get to a truer figure yet, Jake would have to deduct for his out-of-pocket costs for SGA and even for less visible costs like the value of the space in his home that he uses for his business. If Jake were to truly account for all his off-site business costs and also factor in the value of the benefits beyond wages that he received from his former employer, he would see that so far the financial result of his going out on his own is close to a 50% pay cut and not an ascent to a glorious level of profit.

Savvy builders understand profit viscerally. They want to be paid well for the skilled work they put in at their jobsites and for managing their companies. And they know that their companies must register additional earnings, a profit beyond what they pay out to cover production and overhead including owners' wages or salary.

For all that, Jake is not as dumb about "profit" as I was when I was starting out as a general contractor. When Jake spends money on new tools, he does account for their cost as a cost of production, subtracting it along with other costs from the payments he receives from clients. When I was in my start-up phase, I was so enthralled with the wondrous new tools that I was buying that I figured their acquisition to be part of my income from my projects rather than as an expense.

Eventually, as tools began to wear out, it dawned on me that they were not like art works or gold doubloons I could enjoy or exult over for a lifetime. I realized that their costs were a business expense. I began to appreciate the reality of overhead. Jake is coming to the same understanding. If he follows the path taken by another start-up builder I know, he will soon learn to add a percentage of his labor and material charges into his price to his clients to defray his out-of-pocket overhead costs.

Eventually, fearful at each step that he is becoming outrageously expensive and that he will never get another job, he's going to increase that percentage substantially to compensate himself for all the time he spends running his business. Once he does get that far, Jake will be making a good living as a "belt-and-suspenders" builder. Yes, he's working hard—all day on the jobsite, for several hours every evening, and at least one day each weekend. But for a young guy who loves building, being his own boss, and working hard, it's a sweet spot—at least during a boom period like the one

the construction industry is currently enjoying.

When Jake gets to that sweet spot, he will think of himself as running a very profitable business. But he still will not be. Though he is earning more or less market rate compensation (wages plus benefits) for his skilled labor, his business is not making any profit at all. It is only paying its expenses—for materials and subs at the jobsite, for overhead, and for Jake's labor on his jobsites and at running his company.

For a business to be profitable in the real sense of the concept, it must take in more money than it lays out. It must recapture in its charges more than it disburses for production of the goods it sells (construction in our case) and for SGA, including pay for the work SGA requires, whether it is done by owners or employees.

Experienced, savvy builders understand the need for profit viscerally. They want to be paid well for the skilled work they put in at their jobsites and for managing their companies. They also know that just as they must receive pay for their work, their companies must accrue earnings, a profit beyond what they pay out to cover production and SGA. In short, the savvy builders know they need to get paid and that their companies also need to get paid.

In all the various educational channels now available to builders, we hear a great deal about methods of making a profit. Relentlessly, we are advised to do such things as making sure that prospective clients have in mind a budget adequate to allow your company to make a profit before you spend too much time with them; applying markups that help you realize your intended profit; and building protections against profit erosion, such as a clear change order procedure, into your construction contracts and management systems.

But for all the information given us about the how-to of capturing profit, little is said about the *why* of profit, about *why* we must make a profit.

I have come to think that the prime reason that a construction company must earn a profit is to cover specific *profit costs* that are more than likely to hit you. Yes, just as you must recapture your direct costs of production out at the jobsite and the off-site SGA costs of running your company, you must capture profit to cover a whole other range of costs.

Unless you have read my new book, you probably have not heard the term "profit costs" before. I made it up. The reason I made it up is that I have long observed builders getting hit by a variety of costs—often severe or even brutal—beyond what they spend on production and normal SGA including their own pay.

Profit costs are those that go well beyond even the irritating burdens for items like callbacks for leaky faucets and other minor product failures. If you are nailing your numbers, you will have those costs anticipated in your estimates. Like other savvy builders, having concluded they are inevitable even with stringent quality control, you will add small percentages to cover them in your estimates at "project service" or "completion" or some similarly labeled lines.

Profit costs are a different kind of cat. They can be entirely unpredictable as to just what they might be, when they will come, and how much they will amount to. All we know about them is that they almost certainly will strike at some moments during our careers. I've been lucky. I have largely been spared profit costs like those that have badly damaged other builders I know. Even so, I recently was burdened with a long legal battle necessary to protect one of my projects. After two years, I prevailed and prevented neighboring construction that would have seriously impaired my project. But the profit cost was heavy, thousands of dollars and hundreds of hours of work.

It is to cover profit costs—from mis-priced jobs through litigation and recession—that you must make a profit. Stay in the construction business for long, and you are going to experience profit costs, even if you are unusually competent and unusually lucky. You want to be in a position to absorb the hit by some means other than bankruptcy.

A SAMPLER OF PROFIT COSTS

Before Construction Begins

- Pricing jobs too optimistically in order to stay busy
- Delay or serious inefficiency caused by designer or building department non-performance
- Cancellation of a project that leaves a hole in your schedule

During Construction

- Unanticipated and severe inflation of material cost
- Change order conflict, oversight, or neglect
- Prolonged disruption and reduction of productivity by severe weather

After Construction

- Client refusing to make final payment
- Leaks, decay, and other building failures
- Litigation

Anytime

- Injury to yourself or key employees
- Theft and vandalism
- Embezzlement
- General recession in the economy
- Bankruptcy

This sampler is drawn from a longer list of profit costs on page 259 of David Gerstel's new book, Nail Your Numbers, A Path to Skilled Construction Estimating and Bidding.

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You must not only make a profit, you must put it aside for your company. It is not your personal income. It is earnings your company needs to cover its living expenses. You must store it up in an Operating Capital Reserve Account (OCRA). Even a belt-and-suspenders operation like Jake's needs an OCRA. Profit costs are an equal opportunity bandit. They hit us all, regardless of the size of our companies. At his present level of what he thinks of as "profitability," when Jake gets hit with a profit cost, he is going to have to cover it out of the income he counts on to pay his family's bills.

Just how much should you store up in that OCRA? Years ago, I figured 10% of annual revenue—for example, $100,000 for a remodeling company with revenues of a million dollars a year would, I thought, suffice. Later, I revised my guideline upwards to 10% of revenue so long as that was enough to cover a builder's basic living expenses and the overhead expenditures essential to keeping their business in operation for a year. If not, then they needed to go higher than 10%. Why? Because during a prolonged recession, to keep key crew employed, they may have to take work at prices so low their charges to clients do not re-capture their overhead expenses (including their pay) for an extended period. To cover those expenses, they will need to draw on the OCRA.

Now I have come to think of 10% as an absolute minimum requirement. During the last recession, I encountered builders for whom an OCRA of 10% of annual revenue was woefully inadequate. One nearly exhausted an OCRA of a million dollars. Another had to mortgage his home to fund his company. A third reportedly went without pay for several years to keep his business alive. A fourth could not pay the rent for his showroom. None of the four are flakes or fly-by-night operators. All run well-established companies. They have been in business for decades.

Not only do you need to charge profit and store it up against profit cost hits. You also need to charge for it at healthy levels when the economy allows. You need to resist growth in volume that is not profitable, no matter how tempting engrossed revenues may be.

Which business is more likely to sustain against recession or other heavy profit costs: the business with direct costs of $3 million and a realized 8% markup for profit? Or the business with direct costs of $12 million and a realized profit of 2%? I'll bet on the smaller volume operation. Because when a monster profit cost like a recession comes along and prices must be cut, the cuts will swamp the larger company in red ink. The smaller business, even though it will have to forgo profit, will likely be able to stay closer to break even, paying all its expenses including owner's pay with a bit of help from its OCRA.

That's the fundamental why of profit. You need it cover your profit costs just as your other charges recapture your outlay for on-site construction and for SGA.

At this point, you may be wondering, do I ever get to enjoy the profit I work so hard to achieve? Yes, if (and only if) you have created an efficient and effective operation that has been able to top up your OCRA. If you accomplish that, you can begin disbursing further profit as bonuses, and not only to yourself but to your team. After all, the top people in any highly successful enterprise earn and deserve bonuses. But those bonuses are still a profit cost. They are payouts required by the superior performance you and your team have turned in. They are just nicer profit costs than the disaster-driven kind. Here's hoping that you and your team will achieve and enjoy them.

David Gerstel's new book, Nail Your Numbers: A Path to Skilled Construction Estimating and Bidding, *can be ordered from online and brick and mortar bookstores.*