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A 'survival budget' helps win bids

Part three of a multi-part series.

In my April column ("Get high profits with design/build," page 60), I went to a bid opening where 38 landscape companies bid a school construction job. My client finished 10th despite tightening his pricing factors and production standards.

Sure there's a part of you that says, "Let 'em have it at that price." But there's also a thought that gnaws at you: "I will get nothing at my current price if this keeps up." Welcome to the new world. It's hard to define what distinguishes high-profit from low-profit companies in this environment when survival becomes the driving force.

There's only so much past relationships do for you in this environment, so fashion a "survival budget" that reduces costs and prices — and gives you a better chance of generating revenues. A survival budget must provide enough profit to recapitalize the company for next year. Using the chart below, let's review the budget's basic elements.

The starting point is expected revenues. In this example, we anticipate a 50% year-to-year reduction in revenues. We then establish a survival net profit margin. I use 3% as the low-end recap target, which reflects the working capital needed to fund longer Accounts Receivable collection periods and some level of hard asset replacement.

	Good times		Survival mode	
Revenues	$5,000,000		$2,500,000	
Gross margin	$1,700,000	34%	$625,000	25%
Overhead	$1,100,000	22%	$550,000	22%
Net profit	$600,000	12%	$75,000	3%
Assume (no subs)				
Average hourly wage	$15		$13	
Job materials	35%		50%	
Materials	$1,750,000		$1,250,000	
Materials markup	10%		10%	
Labor	$1,550,000		$625,000	
Hours	$103,333		$48,077	
Effective rate	$29.76		$23.40	
Labor cost reduction/hour			15%	
Pricing reduction			27%	
Overhead reduction			100%	

Overhead reduction

We keep overhead in line with revenues at 22% and conclude that overhead costs need to be halved. This is a painful, but necessary step. We add the 3% net margin to the 22% overhead expense to equal a gross margin of 25%.

Labor cost reduction/hour

Given the reduced gross margin expectation, materials costs are now likely 50% of revenues — up from 35%. We can calculate labor expenditures and hours from this assumption.

Revenues of $2.5 million, less $1.25 million in materials, leaves $625,000 for labor. Dividing this by a $13 hourly wage rate yields 48,077 labor hours.

To lower labor cost, we must lower the average wage 15%, from $15 to $13 per hour. Some of this comes from less overtime and some from tighter management of non-billable hours.

Pricing reduction

Lastly, we can calculate the hourly labor billing rate. Revenues minus the materials cost at its 10% markup, divided by the labor hours, provides the rate of $23.40 per hour, 27% less than the prior year. In effect, prices are lowered 27% to achieve the desired margin.

With this survival budget, we can manage through a downturn and still have reinvestment income for the future. Those companies with solid balance sheets (debt-to-equity ratios lower than 40% and current ratios of 2.5 or better) will survive.

It is truly a stomach-churning case of survival of the fittest out there in the bid build world. Be prepared, and next year might look a little better.