Increasing Contractor Profitability

Through Pricing Practices & Mix Management

EGIA™
CONTRACTOR UNIVERSITY

Step by Step to Understanding & Implementing Key Concepts for Pricing Philosophy

A. Purpose of this Pricing Article

To give every contracting company the knowledge, the systems, and the models to be certain that they have a pricing system and that it maximizes their ability to generate a return for the business.

B. Overview

Pricing is one of **the** most critical aspects of operating a successful service company.

You can do everything else perfectly, and if your pricing isn't properly set to recover your costs, and produce a reasonable profit for the company (above 10%), you will suffer the fate of many contractors.

That fate is you run a very good company, try your best to do the right kind of work/service for your customers, but you don't make enough money to:

1. **Pay your employees well enough to be competitive.**
2. **Offer strong competitive benefits to attract employees.**
3. **Establish quality-training programs to improve worker productivity.**
4. **Maintain and acquire new assets such as trucks, computers and install new technology when it makes sense to do so.**
5. **Grow your company – Able to bid larger jobs if desired and support the working capital required to actually get those types of jobs.**
6. **See a 12-15% operating profit after 1 - 5 above are completely satisfied.**

Obviously, **pricing is just one of many areas of running a successful contracting company.** However, it is often one of the most misunderstood and poorly executed areas of business practice.

The following is a list of crucial areas, which can impact profit for contractors, and they are listed in area of maximum impact.

Where is pricing on the list?

1. Leadership issues within the company – Culture – Owners/managers not understanding key principles of leadership – Vision, Direction, Business Planning, Setting Goals, Communication Issues, Training, Coaching, creating accountability, urgency etc.
2. Inadequate financial controls or structure – Lack of quality information, or understanding by owners.

3. **Pricing systems lacking – No pricing strategy, lack of departmental pricing systems – Overall pricing not adequate to recover true business costs.**
4. Labor Control Systems – Keeping labor costs in line with targets by market segment.
5. Quality Installations / Service minimizing callbacks and warranty costs associated with poor quality.
6. Controlling Overhead Expenses – S.G. &.A. to meet targets based on business revenue curve.
7. Materials Management - Lack of Control over purchasing and/or lack of controls for materials used on jobs.
8. Lack of employee understanding about operations and impact of their role on profitability. This is both a communication and a training issue relating to employee productivity and performance.
9. Compensation systems not aligned – Employee compensation systems do not target performance targets that are meaningful to the company.

As you can see from the list of 9 areas for under-performance, pricing is near the top of the list.

Does this mean you can't or won't be successful if you are good at the 9 areas?

No, it does not, yet it will be very difficult for you to get maximum performance from your company if **your pricing systems are not adequately working** together with your company's other key performance functions (systems) such as "How you sell", or "How you advertise". An example is the low cost producer or price leader (meaning low price leader) is not usually geared to sell "Highest Quality". 100% of the consumers surveyed in a Harvard Business Review Study recognized you cannot have the highest quality product / service for the lowest price.

What we do know is the highest performing companies are good at all nine areas. They also establish their prices in accordance with the following:

1. They have a clear, concise business strategy.
2. They have definite operating philosophies.
3. They have defined market segment goals for margins.
4. Their pricing strategy compliments the business strategy and philosophies, and is a system – So recovery of costs can attain the desired margins by market segment.

Almost any company can benefit by reviewing their pricing practices semi-annually and adjusting as necessary. Most companies do this once a year when costs change by suppliers.

Let's examine the fundamentals of pricing. The EGIA site materials are designed for you to learn, then compare your own company and its practices against the models.

Once you have identified there may be a GAP, you can then EXECUTE a Change!

Fundamental # 1

How pricing should compliment business strategies & operational philosophy.

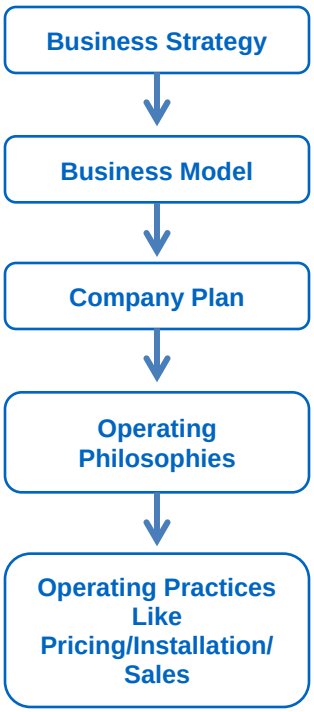
What is a business strategy?

A business strategy is simply the direction the company is focused. It is the acid test for how the company will operate and expend all available resources. An example business strategy is:

A company focused on capturing as many new demand service customers as possible, to convert them over to maintenance agreement customers.

The business strategy here is to bring in demand service customers, then convert them over to maintenance agreement customers. This has many affects, including adding customers, future revenue, smoothing seasonal curves, and offering accessory and replacement opportunities. The strategy also dictates that operationally, it must be good a certain aspects of demand service and maintenance conversion, or it won't be successful.

Pricing, and pricing strategy will be a KEY factor in this process.



Fundamental # 2

Pricing For Various Market Segments

A market segment is an area where a company conducts business (such as retrofit) and that segment has defined characteristics that make it distinct from other markets.

Examples are:

1. Residential Replacement or Plumbing Install
2. Residential Demand Service HVAC-Plumbing-Electrical
3. Residential Maintenance Agreements – HVAC/Plumbing
4. Residential Indoor Air Quality
5. Commercial Replacement
6. Residential New Construction

There are many more, yet in each of these market segments, a company would be likely to have a unique pricing strategy, and pricing system. Each market has unique characteristics that dictate operational practices that will influence costs.

Those operational practices that influence costs make each market different in terms of how pricing must be applied to recover those costs.

Also implicit here, is that our company financial structure allows us to identify those unique costs, whether they are considered direct cost of sales, or overhead (S.G.&A.) items.

The fact that our company operates in varying market segments, and may incur some unique form of costs in each, simply means we need the following items to be in place to price accurately, and profitably:

1. **A financial structure, which provides timely & accurate financial reports/data by segment.**
2. **Integrity and accuracy in how information is given to the accounting function from the field personnel. Many companies fail here!**

Fundamental # 3

How do you decide if your prices are too low or too high?

The market ultimately decides this question. If you cannot sell jobs and are losing them beyond a closing ratio of 35% then most likely your prices are too high – Based on how well you sell!

Reread that last sentence – Based on how well you sell.

In other words, you may not be communicating value, so in this context, your prices are too high. The problem here though is not your price; it is your selling practices.

So once again, how do you determine of your prices are too high? It is done over time, slowly, using what we call price elasticity. Why can some comfort advisors sell a job for $4800 and another advisor can only sell it for $3500. The answer is "Value."

Strictly speaking, your prices are too high when the price exceeds the company's ability to deliver value.

So every company must know what the customer values, put their products and service together to fashion value, learn how to sell they value, and then price it accordingly.

So before you determine the prices are too high for your company, you must first determine that you are providing maximum value at the price points you now occupy.

Pricing is part art, and part science. The part science is the mathematical setting of your prices. The art comes into play by determining how to communicate value and at what price point you can establish the value you offer.

Why is this critical to your success?

- Having a company pricing philosophy is important because it provides the basis point for the company to support its need for margin dollars.
- Having the pricing system set up by market segment will offer the company maximum flexibility in market based pricing.
- **Having a properly formatted and understandable cash flow statement allows us to make more Profits & STAY OUT OF TROUBLE!**

Step by Step for Understanding & Implementing The Profit & Loss Statement

A profit and loss statement is the primary financial statement used to understand business performance.

A P&L tells us about how the company made a profit, and what the profit was? It is a historical statement, meaning it tells us about the previous period it represents, and not the present or future.

There are really two types of profit and loss statements, the detailed version, and the summary version.

1. The detailed version gives all the details of the transactions (see Support Materials).
2. The summary gives only the highlights of the transactions as totals – A summary.

	Retrofit	Service	New Home	Totals
Sales	$100	$100	$100	**$300**
Cost of Sales	$ 50	$ 50	$ 50	**$150**
Gross Profit	$50	$50	$50	**$150**
Overhead Expenses	$20	$20	$20	**$60**
Operating Profit	$ 30	$ 30	$ 30	**$ 90**
Other Gain/Losses	$ (5)	$ (5)	$ (5)	**$(15)**
Net Income	$ 25	$ 25	$ 25	**$ 75**

In this summary example, the company has three market segments, and is tracking them as such. The company made a profit of $ 75 for the period.

Let's take a closer look at the profit and loss statement and define its components and the terms, and please notice the structure of the accounts. This is very important because later, all the industry benchmarks will focus around this structure.

Account Definitions

Gross Sales	-	Any recognized revenue from customers.
Costs of Sales	-	The direct costs associated with doing the work.
Direct Labor	-	The labor costs in the field to do the work.
Equipment	-	The serial numbered equipment on the job.
Parts & Materials	-	The parts & materials to do the job.
Permits	-	The cost of the job permit.
Direct Labor Burden	-	The benefits paid to the direct labor above.
Sales Commissions	-	Any commissions paid as a result of the sale.
Financing/Buy Down	-	The costs of financing or promotions of the sale.
Subcontracts	-	The costs of paying outside vendors on the job.
Warranty Reserve	-	The amount we set aside in case we have a callback.
Gross Profit/Margin	-	Sales minus cost of sales in dollars. Margin is % which is gross profit divided by gross sales.
Overhead (SG&A)	-	The expenses to operate that are not job specific.
Operating Profit (EBIT)	-	The amount of income generated from operations.
Other Gain/Loss	-	Other income, interest, taxes, any losses.
Net Income	-	The net resulting profit after all business activities.

There are some additional terms, and descriptions that may prove helpful.

Separate Materials & Equipment	-	It always surprises me to see these lumped together. They are two distinct and separate chart of accounts and NEED to be. How do you know if you are buying well or not, if they are combined?
Above the Line	-	The costs of sales, the cost and expense that are above the gross profit line.
Below the Line	-	These are the costs or expenses that are below the gross profit (margin) line.
Burden	-	You will hear this term tossed around. The burden or the allocated fringe benefits are the benefits we pay to our field direct labor force only. The company may be paying benefits to everyone, but we segment the direct labor burden out and match it to the direct labor payroll. The reasons for this come clear in pricing, and our direct labor is a large variable on many jobs. When the labor is higher than anticipated on any job, this burden of benefits is as well, where in our normal course of paying our administrative personnel; their benefit burden remains relatively stable.

Departmental Concepts	- This means the profit and loss statement doesn't just lump all the figures into one summary column, totaling the company, like the total column in our example above. We want the statement to break down the performance by how we operate in our markets (Examples are residential service, residential new construction, residential replacement, maintenance, commercial). The departmental concept can apply to sales, cost of sales, and gross profit (margin). It can also be extended to the overhead expenses. Breaking down a company overhead expense into market segments is a good thing, but it has definite requirements that are beyond this current discussion (you can reference the search function and learn more about departmentalizing overhead). In either case, departmental statements do give us more accurate pictures of how the company is operating.
Variable Expenses	- Some of our overhead (SG&A) expenses can be classified. This will help us later when we use the profit and loss to help our pricing systems. We can break these overhead expenses down into variable and fixed expenses. The variable expenses are called variable because they generally increase or decrease, when sales increase or decrease. If we sell a whole bunch, these expenses go up in a measured fashion with the sales curve. Examples of variable expenses are: Gasoline Expense, Vehicle Maintenance.
Fixed Expenses	- Are the expenses in overhead that remain fixed, and do not move even though sales may climb, or fall! Examples of fixed expenses are: Rent, Building Maintenance.

Elements a P&L have structurally:

1. Notice the cost of sales accounts in our example above, and while labor, materials/parts, permits, equipment are standard, **you will notice that sales commissions, warranty reserve, and direct labor benefits are part of these costs.** The reason, because they are part of the cost of sales – not the selling expense, but after we begin installing a job, these are costs that track against the jobs labor, making them apply to cost of sales. So many contractors lump all their benefits into an account called benefits. What if the labor goes to long on the job, overhead will look too high because the benefits are down there for the extra labor all lumped in with our support staff. You must separate direct labor benefits out and cost them above the line in cost of sales! **Also, many contractors do NOT EVEN HAVE a WARRANTY RESERVE?** Are there **never** any failures? Of course there are, and we need to track them, so we can price for them! Some warranty costs run as high as 2%. If we are not accounting for this in cost of sales, then where? You guessed it, lumped into that massive labor account!

2. **THERE'S NO SUCH THING AS UNAPPLIED TIME:** Eliminate this account. You should not have an unapplied time account on your profit and loss or in your chart of accounts, because all time is applied somewhere. Track

your labor. If you trained someone, place the labor cost in training, not unapplied time. Wherever your labor went, allocate the costs to a chart of account. Unapplied time is an excuse to have labor dollars flowing into a spot where no one can be accountable for them.

3. A Profit and Loss Statement should match departmental operational characteristics – Meaning whatever markets you actively do business in; they should be called out and tracked as a department so you can determine if you make money in this market.

4. A Profit and Loss Statement should have dollars and percentages (both).

5. A Profit and Loss Statement should compare your performance against a budgeted figure so you know where you stand against your plan.

6. A departmental profit and loss should detail the overhead expenses (SG&A).

7. A departmental P&L should show the operating income, so the company understands the performance of operations as a percentage to budget.

8. A detailed departmental P&L should show any other gains of income or losses.

9. A detailed P&L should show the net income as a percentage to the planned budget.

The whole point of being detailed is so you can compare yourself to the industry standards. You will want to reference the industry standards for each chart of account as you move along!

To understand the detailed profit and loss statement, follow these steps:

1. First, your profit and loss statement must be organized the way you want it to be.

2. Your accounting team must be diligent in allocating the sales, and costs into the accounts (Chart of accounts detail) that deserve the revenues and costs, or your organization will all be for naught. Many contractors have good organization, but lump all warranty labor calls into service labor, severely affecting the service department labor, making service look unproductive. Therefore, the organization must be good, but you also must be sure accounting and the field labor teams understand how data gets entered into the profit and loss statement.

3. Your profit and loss statement should help you identify how you performed in a given market place.

4. Your profit and loss statement should guide you in determining if you need to make mix changes, for example, increasing sales and margin dollars in an area to increase profits. Sometimes higher margin markets are attractive and can be lucrative if you simply spent more time developing them.

5. Your profit and loss statement should also guide you in learning if your pricing systems are recovering your expenses properly. Making assessments from the performance numbers off of the P&L take experience, but you can refer to the EGIA Residential industry financial benchmarks to compare the company to the profit and loss in virtually every market segment to see how your performance stacks up against top performing companies.

Why is this critical to your success?

- Your P&L should be detailed enough to give you the data you need to make good decisions.
- The detailed profit and loss should be your guide to making significant changes to improve financial performance.

The organized, detailed, up-to-date P&L helps you MAKE MORE PROFITS!

Step by Step to Understanding & Implementing Key Concepts for Departmentalized Profit & Loss Statements

A departmental profit and loss statement can take the shape of differing forms, and it can become tricky when allocating overhead.

If you have a departmental profit and loss statement already, you probably understand its importance to operating effectively, and improving the decision making process. One of the keys to maintaining the decision making process is to decide on a few issues:

1. When do I add an additional department to my profit and loss statement?
2. If I want to departmentalize my overhead, how do I go about doing this?

When to add an additional department?

Consider these factors when adding a new department to your profit and loss tracking:

1. How much work are you doing in the market segment?
2. How much work do you plan to do – in other words are you entering a new strategy or a new market and dedicating resources to make sales occur?
3. Do you have the need to determine the pricing that will come from the important profit and loss statement?

If you are departmental down to the gross margin level in your profit and loss statement, so long as you know the proper or desired gross margin requirements for the market segment, you can effectively price your products and services.

And while there are no hard and fast rules for adding more departments and structure, here is the basic guideline we recommend:

1. If you are entering into a new market – go ahead and do it so you can determine how effective your performance was based on your investment.
2. If you are selling more than 5% of your products and services in any segment of the market, it is probably worth adding the department to the list – if you are growing the segment. Since the growth is occurring, it can obscure your profit margins due to the increasing mix changes occurring.
3. If you want to set up departmental key performance measures – it is always a good idea to know what the performance is if someone is being held accountable for departmental performance.

Obviously if you are adding departments, you will recognize the need to adapt your chart of accounts and your accounting ledgers and codes, adapt your time tickets, invoices, forms and all other impacted areas.

Allocating departmental overhead is a little more complicated.

This is frequently asked and often a misunderstood subject.

When should I allocate my overhead? Isn't it a better way to have accountability?

The departmental allocation of overhead can be complex, but there are some basic guidelines to consider before you actually do it:

1. Ask yourself why you are doing it?
2. Understand there are more administrative tasks associated with allocating and departmentalizing overhead – Are they worth it?
3. It usually doesn't make sense to begin thinking about allocating overhead until the company is large enough to benefit by the process of doing so. This size is highly personal, yet experience as a guideline suggests somewhere around 6 million in revenues leaves the company enough employee separation of duty and focus in areas of the business to begin to make sense. 10 million is a much better point, but this is a highly personal choice, and we have seen companies successful at 6 million, and some that have made it a travesty at 6 million due to employee infighting about crossover roles and who deserved the overhead costs!
4. It is also a must that the company has the accounting competency to make the transition from departmental statements at the gross margin level, to departmental overhead.

5. Depending upon the reasons you are making this consideration a reality, be prepared for some employee gnashing of the teeth, due to the growing and learning pains that will come with this process.

Understand the Steps to Allocation of Overhead

1. Whatever method you use, you must commit to remaining consistent or you will lose the year over year comparisons you will want to have.
2. No one standard method is full proof from making some parts of the overhead costs allocate to a department, without looking out of line with what the department actually used in terms of overhead. The methods are:
   a. Percentage of Sales
   b. Percentage of Labor Hours
   c. Management Discretion
   d. Combination of any of the three above.

Let us discuss these practices.

The percentage of sales method is the easiest method. Accounting simply calculates the sales mix of each department and breaks out any overhead expense in this ratio.

The problems are obvious. Does the commercial installation department deserve to bear the burden of yellow page advertising, or a marketing home show expense? Also, commercial sells a one-time large job because the bid was low (is this effective marketing?) and whammy, a large chunk of overhead is flying your way. It would be a difficult case even for Johnny Cochran!

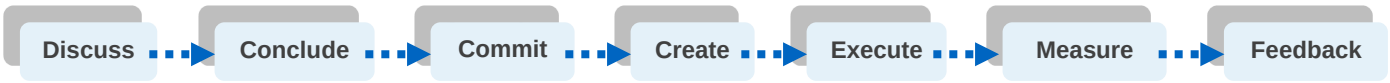
The percentage of labor hours method is next, and like sales, we simply calculate the ratio of labor hours each department used as a percentage of our totals, and use the assumption that labor drives overhead (it does by the way), and that this assumption allows us to break out all costs of overhead by the labor hours used.

Same problem as percentage of sales, although is a more accurate, it still assigns burden across all overhead accounts, **not allowing for the idea that markets segments of the company have different expenses that apply to developing sales.**

Next method is management discretion where the head of state, the chairman, the pope, and the governor, whoever decides on the basis of what he/she believes, is fair. So commercial does not get the overhead for yellow page ads, but does get the golf membership at the club? This method is fine, and it has the advantage of discussion, because there will be lots of it. Bottom line is as a leader; you probably don't want to put yourself in the position of deciding what is fair or not on every single chart of account.

Last method, the combination of sales, labor hours and management discretion. Best method. Get you teams together, and have them review the chart of accounts, one by one, and come up with a conclusion about what

overhead account needs what method. Some are best based on sales, some on labor; some need a management decision (like where you put the owner's salary and how it is spread?). Here is your model to use:



Once you have decided what account, in what department applies, you can apply the overhead costs to the accounts in the varying departments. Stay as consistent as possible over time.

The weakness of this method is some may feel it can be complicated, and at first it may be. The discussion phase can be intense. If people in your organization are being paid on performance, this can be a sensitive subject.

Remember to change the new performance based pay plans to fit the new allocated overhead structure.

Allocation of departmental overhead is a good step if you are ready for it!

Why is this critical to your success?

- Adding departments to the tracking of your profit and loss statement can be effective in compensation plans, and learning about your business growth, and business mix.
- Departmentalizing your overhead can be tricky, but when it is done well, it makes the company more effective and more accountable for the performance in the market.
- A well-organized allocated overhead structure leads to a pricing effectiveness that cannot be attained with only gross margin level departmentalization. Truly knowing the overhead in any given market segment allows total flexibility in pricing methodology, and greatly improved accuracy!
- **Having a detailed accounting structure, with a fully departmental profit and loss statement is an extremely effective way to MAKE MORE PROFITS!**

Step by Step to Understanding & Implementing Pricing and Business Mix Management

Business mix can be impacted by pricing strategy by the type of work we bid-accept.

We often talk about business mix, but what do we really mean?

The company business mix is the percentage of sales and gross margin dollars in any given market segment that when divided by the total of all sales of the company, we get a percentage of the total.

An example is a company that sells $1,000,00 in revenues a year, and $500,000 of this is new construction. The business mix of new construction is 50% or ½ the total revenues. Interestingly the same company also gets $400,00 in gross margin dollars from the $1,000,000 in revenues or 40%. The new construction department produces a 20% margin (20% x $500,000 = $100,000), or $ 100,000 margin dollars. So new construction contributes only 25% of the company margin dollars even though it contributes 50% of sales. And there is the issue right in front of us about what business mix is all about.

If this above example was a real company, here are some issues:

1. Does new home contribute enough margins for the company?
2. Can the company redirect some resources and grow some other segment?
3. In the example, we get $ 300,000 of our total of 400,000 in margin from service and replacement work, so that is a 60% margin percentage (300/500 = 60%). Would it be wise to consider growing this highly lucrative segment?
4. Perhaps we should consider a different selling approach to our builders?
5. Maybe we should analyze the builders, there could be one builder sucking up all the resources and labor, and producing a low sales amount in our new home market. If we dropped this builder perhaps the resources could be used to find a different builder and improve the overall gross margin dollars.

These are some scenarios we face when we deal with business mix management.

I have heard some contractors question if they can impact their business mix all that much? Can they? The answer is yes, of course they can. You choose whom you do business with, especially in construction, and while there are practical reasons not to walk away or change your pricing so you lose the work, there are the reasons we see above to consider all the alternatives.

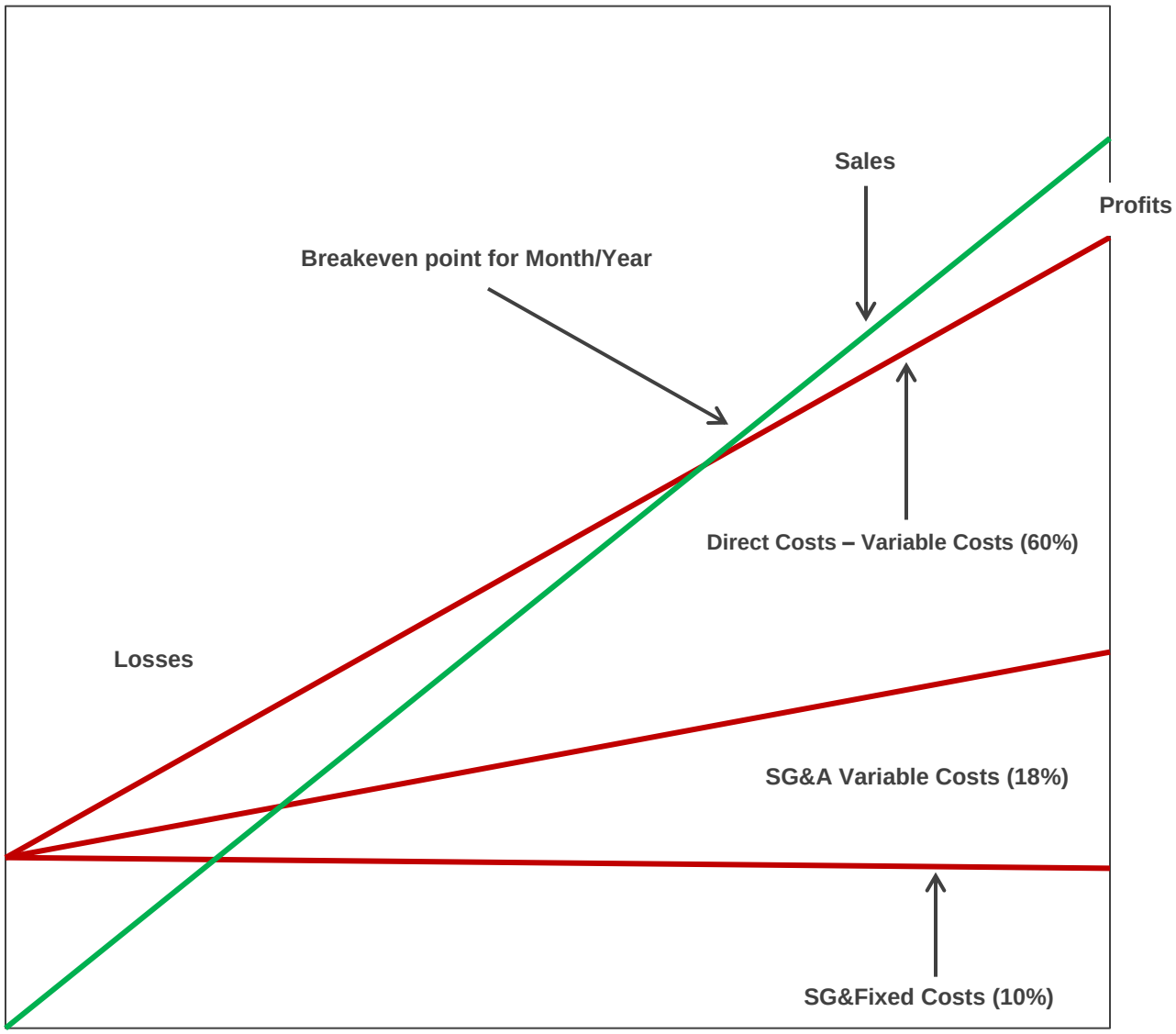
So how does pricing play out in this conversation?

The answer lies in the way contracting overhead tracks with sales- on the basis of labor. Labor is the driving factor in our contracting business, and the more labor hours we work as production direct labor, the more increases our overhead will sustain.

Review the graph on the following page to understand this concept.

As we sell, we incur costs. These costs are cost of sales (labor being one of those), and overhead (SG&A) of which the overhead has fixed costs and variable costs. It is these variable costs that go up in concert with added labor hours. Imagine a job that takes longer than planned, and has extra visits!

Breakeven Analysis Representation – Applied to Mix



Notice as the sales curve rises, the variable costs curve also does also. Imagine then, if in this very same diagram of a job, or a company's year, the labor portions of the variable costs began creeping up higher and higher. As you can see, it would shrink the profits.

So jobs that are high in labor and low in material costs, have a tendency to drive our costs higher, both the labor component, and the operating expenses that get pulled along.

The optimum is to target high material low labor jobs, and of course always have a labor control system in place or fix the labor cost as a % of sales on high labor low materials type work.

How do we use the concept of business mix?

1. Manage the type of work you target for the company – Higher margin work, through price practices yields higher overall company margins.
2. Pay close attention to how you can manage your pricing to gain maximum margin dollars out of even the toughest of builders or construction companies.
3. Consider the idea of firing customers through price management practices. Be professional, but raising your prices is one way to rid the company of the business gracefully, or gain margin dollars if the price sticks.
4. Learn the value of being selective about your mix you take within the market segments. Taking higher material jobs where the costs remain static and can be easily handled without driving up labor hours and requiring overtime are preferable jobs to the higher labor work like cut-ins in construction, or adding returns. These are not always jobs you can walk away from, but in these cases you can defer the work until off peak seasons by offering a discount or incentive, or simply price the work to meet the gross profit dollar per man- hour requirements you desire (see later pricing section on gross profit per man day).
5. Part of mix management also is the addition of bundling services, or accessory sales on jobs. One can improve the margin of the job and of course the company by employing the strategy of including certain accessory items and learning to bundle them in concert with the overall job (positioning strategy). Just a few accessories a week can add up to very large margin dollar changes at the end of the year, essentially adding similar size profits to the bottom line.

Why is this critical to your success?

- Business mix is going to happen whether you manage it or not, so don't get caught without enough margin dollars. Learn to manage the mix on all levels:
    1. Company type of work chosen by market.
    2. Choosing specific types of jobs by labor and material.
    3. Individual jobs – Managing and adding margin dollars by crew day.
- Establish pricing systems that help you manage you mix by targeting certain gross profit dollars by market segment, as the desired performance for the company. The pricing system will support the recognition you want more margin dollars. The Dual Overhead method is on example, or gross profit per man-day pricing is another.
- **Managing mix definitely impacts profits, and having a pricing strategy that identifies certain types of work the company is targeting can help you make more Profits & STAY OUT OF TROUBLE!**

Step by Step to Understanding & Implementing Residential Replacement Pricing

Residential Replacement is one of the most lucrative markets in our industry, yet many contractors underprice this market!

1. They do not understand their costs.
2. They do not effectively communicate the value they offer.

Most contractors in the HVAC industry are involved in the replacement market in some manner or another. It can, and should be the single most profitable market we do business in, yet you will often hear contractors **complaining about the guy over there that muddies the market with low prices, and he'll probably go out of business soon! He's killing my profits! I can't make money with him screwing up the market!**

Sometimes they do go out of business and sometime they do not! In many cases the contractor being described above is simply working for day labor wages on any job they price and install, and that suits him perfectly fine. By the way, they are NOT going to go away. A new one always takes their place!

So both issues are in play:

1. That contractor does NOT understand costs or he chooses to ignore the fact that he deserves a salary as an owner and should be making 15% profit AFTER he pays himself a salary. Meaning he is cheating on his overhead burden (Cheating himself).
2. If this guy bothers you, **your company DOES NOT GET IT** when it comes to separating yourself from this type of contracting firm, and creating perceived value to the buyer.

So we are dealing with two issues, the need to get the costs and margins correct to meet your company needs, and the need to establish value! This material ONLY Deals with price establishment! (see value).

Getting the replacement pricing right is a critical success factor for any company. It takes a great deal of work to do this properly. It may seem complicated, but what it really is; is detailed!

Replacement pricing also relates to many aspects of running our business such as:

1. Market research – Knowing what the market can and will bear.
2. Installation production efficiency – Bad efficiency can kill your profits.
3. Pay systems for our labor and sales teams.
4. Seasonal issues – When our board is lacking we have a sense of urgency.
5. Quality control – Bad quality means bad reputation, means lower prices to get jobs!
6. Company image in the market – Good/bad/none?
7. Sales Processes – Ability to communicate value and understanding competition.

8. Our suppliers and the type of equipment and extended services they offer – IAQ, extended warranties, longer equipment warranties, their features and benefits.
9. How each position that our suppliers products and our own services – Tiered, or not?
10. Our own business philosophies and objectives. Example: Loss leader maintenance pricing for no profit to gain share of market and customers.

We must factor and tie all of these areas together as we formulate our pricing strategy!

Getting the costs correct and learning to establish prices:

Some rules of the road!

1. We must have a pricing strategy. Bundling of warranty and service agreements with certain equipment is an example, and creates the residential product positioning strategy (See establishing value). The strategy we use dictates how we will price.

Platinum	**Gold**	**Silver**	**Bronze**	**Tin**
Supreme	**Premium**	**Standard**	**Basic**	
Best		**Better**	**Good**	

2. We must identify all our costs in a standard format so we can set a price.
3. We must establish market-based prices, what the market will bear, in order to have enough understanding of how we can price. This means knowing the competition, and who the higher end players are, and who the low-end players are. What products and services they offer and what they do in terms of discounting.
4. We will always price to a minimum gross margin level, and adjust upwards to the market level so long as the market is higher than our desired gross margins. We always price to market. The market sees to it! If you find yourself higher than the market, learn to establish the value. (See Lexus cars for the prime example – After all it is just transportation).
5. We must have a policy for discounting. When we will discount, how many levels of discounts do we have, and if we are going to tie sales compensation to these discounts.
6. Discounting should be tied to sales compensation – “Shared Pain” we call it. The company always gets paid first and foremost, then the employee. Why would we allow a discount to occur without having the sales compensation decline by a linear (similar amount)? We both want the work, but we both should have to give, as a proper incentive for the sales team to learn to communicate value to our customers.
7. We should be certain to have a defined labor control system in place when we establish our prices. Labor is critical variable and can eat profits like PAC-MAN!
   a. We either have a pay for performance system to tie productivity to sales.

b. We track labor religiously.

c. Use a compensation system for direct labor like piece rate.

8. We must maintain a reasonable overhead structure. The market does not care about your inefficiency. If your overhead is too high relative to the rest of the good HVAC businesses out in the market, why should someone pay you more? SG&A or overhead should be no more than 30% of company revenues, preferably around 27%, and remember to view overhead as a dollar amount per day – Or crew day.

9. When we look at overhead per crew day, we divide total replacement overhead by the (days sold) available install days for the year multiplied by selling efficiency say 65% sold.

Look at the costs for replacement pricing:

Example:

Equipment	$1,405
Material Cost	$507
Labor Cost	$323
Other Direct Cost (permits/subcontracts)	$250
Allocated Labor Fringes	$77
Warranty Reserve	$100
Financing Buy Down	$0
Total Cost of Sales	$2,662

Overhead of 28%: (includes an owners monthly salary figure and all SG&A expenses)

Commission 5%

Desired Net Profit 15%

These are the basic direct costs of an example job. They represent costs associated with the sale of the job.

To see how these are figured in detail, check the following pages.

There are several methods we can use to create a price once we understand the costs.

1	Divisor	Not Good Method	Simplest
2	Multiplier	Not Good Method	Simple –Need P&L Structure
3	GP Per Man Day	Good	Simple P&L - Easy
4	Dual Overhead	The Best Method	Need Good Financial Structure

For our purposes here, we will explain the divisor method. Additional EGIA site materials are available on how to use the other pricing methods and why you may consider using them.

$$\frac{\text{Direct Costs}}{\text{(1.0 - Desired Net Profit + Overhead + Commission)}} \qquad \frac{\$2662}{(1 - .28 + .15 + .5)}$$

Is the same as $2662 divided by .52 or what we call the divisor and the total sales price is $ $5119.23 or $5120? You're not done yet.

The $5120 would need to have added to it any extended warranty sales you might be marketing. In this case we are not offering one, so the final price is in fact $5120.00.

Review the detailed spreadsheet on the following two pages, and refer to the EXCEL file for your own calculations, enter the information in yellow to create your divisor prices.

	Make	Model	1 TON
Condenser			$ 700
Electric Heat / LP Kit			$ -
Furnace			$ 465
Coil / Air Handler			$ 142
Sub-Total Equipment			$ 1,307
IAQ Equipment			$ -
Add on Items			$ -
Tax Rate and Applicable Tax Dollars		7.50%	$ 98
Total Equipment Costs			$ 1,405

Sheet Metal			$ 472
Flex Duct			$ -
Overflow Drain Pan			$ -
Thermostat			$ -
Condenser Pad			$ -
Electrical			$ -
Refrigerant Charges			$ -
Miscellaneous			$ -
Refrigerant Lines			$ -
Sub Total materials			$ 472
Tax Rate and Applicable Tax Dollars		7.50%	$ 35
Total Material			$ 507
	Hours	**Avg. Rate**	

Total Labor Hours / Cost Per Hour- No Benefits	10	$ 32.25	$ 323
Overtime	0	$ 48.38	$ -
Shop Labor	0	$ 32.25	$ -
Delivery & Staging	0	$ 32.25	$ -
Total Labor			$ 323
Labor Fringe @ 24 %			$ 77

Permit			$ 25
Subcontractor			$ 225
Other			$ -
Warranty Reserve			$ 100
Enter Overhead Figure - Desired SG&A %		28.00%	
Bottom Line Commission %		5.00%	
Desired Net Profit %		15.00%	
Total Costs			2,662
Gross Margin % (Overhead + Commission + Profit)			48%
Gross Profit in Dollars			2,458
Sub-Total of Sale before Extras (Using Divisor)			5,120
Service Agreement/Ext. Warr. Price (no added markups)			0

Bottom Line Sales Price (Shared Pain Commissions)			5,120
Second Drop 5% Discount (Shared Pain Commissions)			5,389
First Drop 5% Discount (Shared Pain Commissions)			5,673
Retail Price (Commissions at Full Rates)			5,972

Equipment % Bottom Line			27%
Parts/Material % Bottom Line			10%
Direct Labor % Bottom Line			6%
Ratio of Gross Margin Dollars to Labor Dollars			6.67
Other Direct Cost			0
Commission Expense			307
Financing Buy-down - Dollar Amount			0
Total Other Direct Cost			307
Actual Gross Profit			2,150
Actual Gross Profit % Bottom Line			42%
Total SG&A Expenses - Allocated to this work.			1,434
Net Profit on Bottom Line			717
Net Profit % on Bottom Line			14.0%

Net Profit % Second Drop			**16.6%**
Net Profit % First Drop			**18.1%**
Net Profit % Retail Price			**19.4%**

How do we use the concept of residential pricing?

1. Establishing proper residential pricing is critical to attaining margins. It takes a certain amount of overhead to operate a business successfully, to promote, advertise and train the sales personnel. The margins in the retrofit department need to be at 42% or better to sustain the 15% profit margin, even in a lean well ran company.

2. Learn to set a positioning strategy in place, where customers have choices to make, and you can make money on any of these choices, but especially the higher end products.

3. Learn to bundle your products and service. On the higher end products, add a service agreement, and an extended warranty to the product bundle. This improves the positioning, meaning it creates uniqueness, and separation from the other offerings you are making.
   - Service Agreements
   - Extended Warranties
   - Duct Cleaning, Accessories
   - IAQ Products
   - New Thermostats
   - Upgraded Ducting Systems

4. Consumers will choose buy these criteria:

   10% Choose on Price
   83% Choose Best Value
   7% Status – The Best

   Based on this data why wouldn't you offer a few value-based options, knowing that most customers are buying what they perceive to be the very best value for their selves.

5. Consider how you are going to communicate the value-price relationships (see further articles).

6. Use pricing systems that make sense for your company. Using the dual overhead method is great, but you had better understand how to do this, and you need the right financial structure to support you.

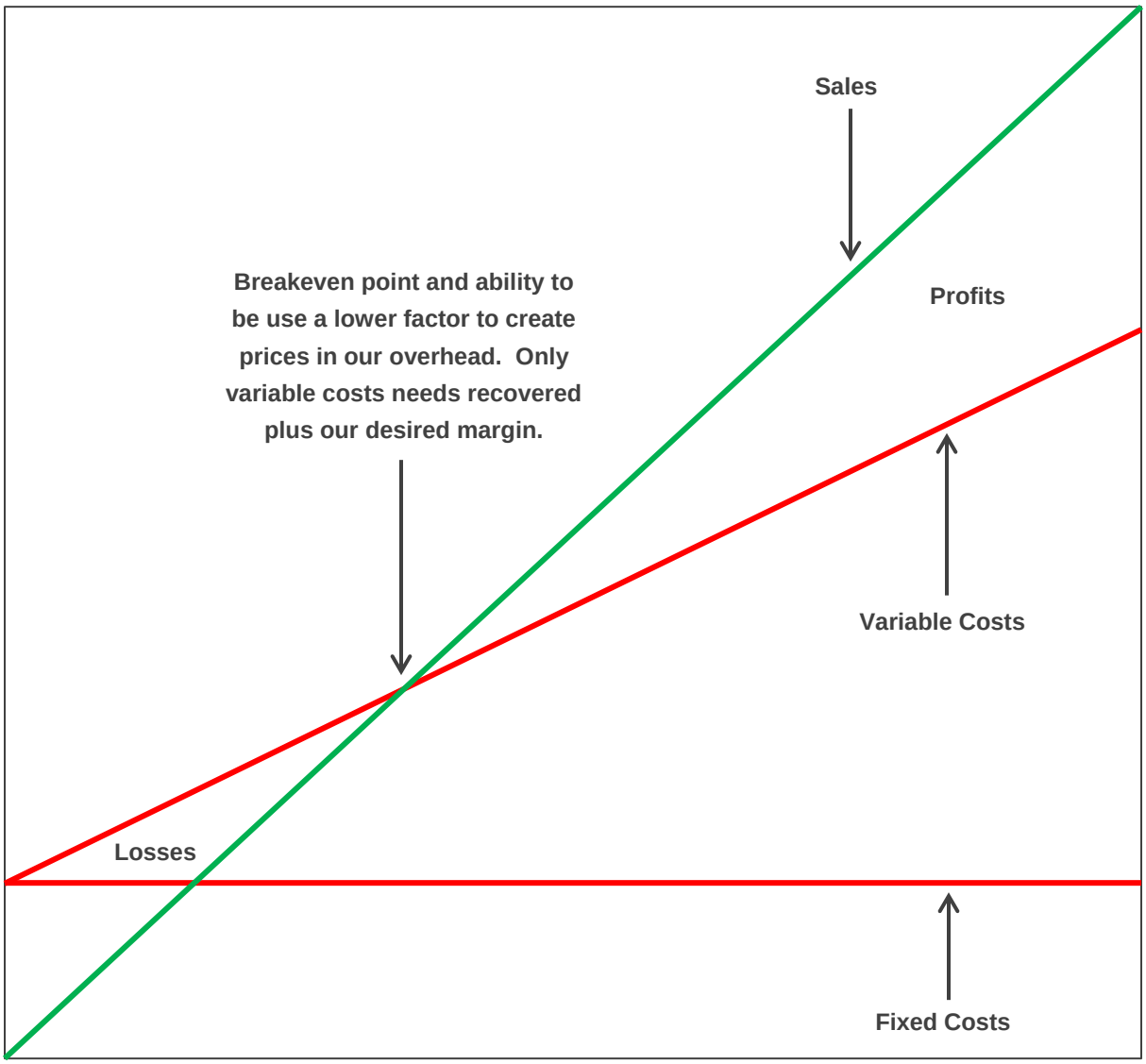
7. Use breakeven pricing as a strategy if you feel comfortable with the knowledge (EGIA has a specific article on using breakeven) - Refer to the next page for a table referring to its uses.

8. Some factors that influence price: Seasonal Demand, Sales Promotions, Good Competition, Your Labor Efficiency, Your Operational Efficiency, your Job costs (how you buy), Your Overhead Costs, Your Sales

Commissions, Your extra adders for services and accessories, Your attitude, Customers Attitudes, Your quality, Your Company Reputation and image, Your Suppliers products, New Sales People, Your Discounting Strategy or lack of one, Neighbors!

9. Some factors that **DO NOT** negatively affect Price; Bad Competition - The guy who is low on the street. He is actually your friend, because he is giving you a chance to explain why you are better on many leads that you may never see if his price wasn't out there gathering attention.

Break-even Analysis Representation – Applied to Price



After you reach breakeven for the month, or for the year, you have some level of pricing flexibility. This is why some contractors seem to change their prices late in the year.

You fixed costs have been totally covered once you have reach breakeven for the year, and now you have the ability to price, using the variable costs in your business.

It is an excellent strategy, but also one that you should think through carefully because adapting your prices has consequences. Neighbors talk. Price points get established for this type of job. Pricing communicates our "Value", so be very aware and careful about using this approach.

Why is this critical to your success?

- Residential pricing in the replacement market is one of the most important areas of our business.
- As we set residential pricing, we need to understand how important it is that we set the prices correctly for our costs and to recover enough margin dollars to make money with our overhead, but that we also understand how to communicate the value we are asking for our price.
- Having all the issues outlined on page one covered before we begin adjusting our prices is very important.
- Continuous adjustment of our prices is necessary as the market changes, products change, and we change.
- **Proper pricing systems and proper communication of value offer you a great chance at making double-digit profits and definitely will help you make more Profits & STAY OUT OF TROUBLE!**

Step by Step to Understanding and Implementing The Dual Overhead Pricing Method

Dual overhead is considered by some to be a complicated system of pricing, when really it is very simple. If you are used to using the Divisor method, or multiplier method, you will find the dual overhead method different than the others, and you may also find it produces a more accurate price for the products and services we provide in contracting.

Dual overhead uses the premise that labor hours or a company use of labor drives overhead expenses, meaning the more labor hours used, the more overhead will rise. In contracting, this is a valid assumption and has merit for your consideration.

The dual overhead pricing method does require a company to have a strong financial framework in order to be certain the figures used in the dual overhead calculations are up-to-date and accurate.

How does dual overhead work?

Dual overhead pricing uses the company's overhead to create two factors used in setting price.

1. The 1st factor is what is called a Materials factor (from our materials/equipment and non-labor costs).
2. The 2nd factor is what is called a Labor Factor (from our labor costs).

The two factors are created from the company's financial operating characteristics. We will use the historical records of the company so we have a broad view of the costs, and do not get caught-up in a short window of cost variations.

The dual overhead system is based on the direct cost of sales for the financial information. These are once again defined as direct costs only and look like this for the industry standards:

Revenues:

Direct Labor
Direct Labor Benefits
Warranty Reserve
Subcontract Expenses
Job Start-up Labor (typically commercial only)
Materials & Parts
Equipment
Sales Commissions
Permits

} **Direct Cost of Sales**

So we will use the totals of (Materials / Parts/ Equipment / Subcontractors / Permits) for the materials factor and the (Direct Labor / Warranty Labor / Labor for Start-Up /Direct Labor Benefits) for the labor factor.

No two companies would end up with the same factors, because like people, all companies have different overhead rates, different labor costs, and would bid jobs differently.

What is important to understand is that your company factors are the only factors that matter, and so long as you run an efficient company, the system will work for you.

What is important to understand is that your company factors are the only factors that matter, and so long as you run an efficient company, the system will work for you.

How do I calculate a price using the dual overhead method?

Dual Overhead Ratio Method

Great for Commercial, or New Construction Bid Process

Direct Costs	Dollars	Percent @ 10%
Direct Labor Dollars (non-burdened)	$ 350.0	14.42%
Equipment Costs	$ 950.0	39.15%
Materials/Parts dollars	$ 300.0	12.36%
All Forms of Unapplied Labor Expenses Added	$ -	0.00%
Subcontracts	$ 50.0	2.06%
Allocated Fringe Benefits	$ 84.0	24.00%
Job Start-up Costs	$ -	0.00%
Warranty Expenses (Reserve) - & Extended Warranty	$ 25.0	1.03%
Permits	$ 50.0	2.06%
Buydowns for Financing	$ 30.0	1.24%
Equipment Rentals	$ -	0.00%
Total Direct Cost of Sales	$ 1,839.00	75.79%
Selling expenses (Direct Costs)		
Commissions	$ 48.53	2.00%
Total Years Labor Dollars - Full Year or Budget	$ 600,000.00	
Total Years Material/Parts/SUBS Dollars - Full Year or Budget	$ 800,000.00	
Overhead Dollars - either last full year or budget year	$ 275,000.00	
Overhead Factor for Materials & Parts (MOM)	1.15	
Overhead Factor for Labor	1.26	
Breakeven Sales Price (NO PROFIT ADDED YET)!	$ 2,163	

Sale Price @ 10% Profit (Markup factor multiplier of 1.1* Breakeven Costs plus Commissions)		$ 2,426	
Sale Price @ 15% Profit (Markup factor multiplier of 1.18 *Breakeven Costs) plus Commissions		$ 2,537	
Sale Price @ 20% Profit (Markup factor multiplier of 1.25* Breakeven Costs) Plus commissions		$ 2,647	
1.15	Materials Factor - or Materials Overhead Markup(MOM)	$ 1,611.99	This is the jobs Material Breakeven Costs
1.26	Labor Factor - or Labor Overhead Markup(LOM)	$ 547.67	This is the job Labor Breakeven Costs

Higher labor jobs priced with multiplier or divisor methods will yield prices that are too low to recover overhead associated with HVAC Business. Overhead is proportionate to labor in HVAC, so the higher the labor, the more likely overhead is to be higher associated with each high labor job.

Check multipliers frequently - 1 time a month recommended. Adjust MOM, and LOM when overhead changes in a significant manner within company.

Subcontractors are considered materials since there is very little overhead attached to a subcontractor. Also, rentals, permits etc...

Labor includes all forms of direct labor expenses associated with the direct cost - allocated fringes, warranty labor, job start-up, unapplied labor

Step 1 - MOM = (Full Yr. Labor $/Full Yr. Material $ x Overhead)/((Full Yr. Labor $+ Full Yr. Material $) + 1)

Step 2 - LOM = (Full Yr. Materials $/Full Yr. Labor $ x Overhead)/((Full Yr. Labor $+ Full Yr. Material $) + 1)

Step 3 - Calculate Labor Figure on Job - (Multiply LOM * Total Labor Costs on Job)
Step 4 - Calculate Material Figure on Job - (Multiply MOM * Mater/Equip/Subs)

Step 5 - Calculate Breakeven on Job - (add the LOM Costs + MOM Costs) = $$ Breakeven

Step 6 - Choose a Profit Multiplier from page 47 table - (Multiplier * Total Breakeven) Equals Job Sale Price

The dual overhead formulas are as follows:

Higher labor jobs priced with multiplier or divisor methods will yield prices, which are too low to recover overhead associated with HVAC Business. Overhead is proportionate to labor hours/dollars in contracting so the higher the labor, the more likely overhead is to be higher associated with each high labor job.

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Step 3: Calculate Labor Figure on Job - (Multiply LOM * Total Labor Costs on Job).

Step 4: Calculate Material Figure on Job - (Multiply MOM * Mater/Equip/Subs).

Step 5: Calculate Breakeven on Job - (Add the LOM Costs + MOM Costs) = $$ Breakeven.

Step 6: Choose a Profit Multiplier to add profit to breakeven - (Multiplier * Total Breakeven) equals job sale price.

How do I use dual overhead to my benefit?

Dual overhead allows you accuracy to bid jobs that are closely related to how we as contractors perform our work. Meaning when you run into a highly labor intensive job, dual overhead factors in the idea that more labor means more future overhead, so we better get paid to cover that fact.

It also works the opposite way, that when you run into a high material low labor job, dual overhead it going to yield prices that is more competitive in your market.

Remember your company overhead is not static. Labor hours in our direct costs can and do drive-up variable costs, such as vehicle expense, gasoline expense, small tools wear and tear, uniform expense, training, even the more hours we use in direct labor the higher the risk for a workers compensation claim (just look at how insurance companies set the workers compensation premiums – payroll costs).

Also a key point to make referring back to pricing strategy and that is we always price to market and accept what the market will bear, even though we may have the ability with our company efficiency to be less than that market price. At least you know where you could be if you needed to be from a negotiating standpoint.

Why would I switch to dual overhead?

1. There are a few reasons why. No matter what market segment you are pricing for, dual overhead is the most accurate method of arriving at a price based on your company financial characteristics.

2. Dual Overhead gives you the peace of mind of knowing where your breakeven is, and the ability to know how much profit you are making at a given price point. You decide how competitive you want to be.

   A company that is fully departmentalized in the profit and loss statement, so as to know the overhead dollars in new construction, commercial construction, and all other areas of the company, dual overhead offers a third reason.

3. The accuracy of allocated departmental overhead gives the company maximum competitive advantage in the market to determine breakeven price, and choose how close to breakeven they want to be if they need to be.

To better understand how dual overhead compares to other methods:

Go ahead, blow them up and see the message. This is how dual overhead compares to other price methods. They all work fine. Each will produce a price. Some methods simply let you see things that other methods do not. Dual overhead gives you a price that is far more representative of what your company looks like operationally. The financial numbers are your company numbers, and the job figures are your estimates, so it is a highly focused, custom method to pricing, and it is the most accurate. View the EXCEL file for the comparisons side by side of the very same job costs, and see the variations in price between Divisor, Multiplier, and Dual Overhead. People will often say, "How can that be?" Look down again!

From 100 feet away you see:

From 10 feet away you see:

From 1 foot away you see:

Dual overhead pricing won't get you any more jobs, but it can put you in a position to decide how you want to bid them due to your clarity about the costs involved on the job.

A high labor job may begin to look less attractive to you if your job board is full, or nearing full. You may elect to tender a price that is higher than normal, or if the job board is empty you may choose to price the job competitively, knowing that the margin isn't great, but it is keeping your labor force working for you and not your competitor.

The divisor method is great because it is easy to understand. It just doesn't take into account certain types of work matter as much as the costs of the work. Divisor doesn't accommodate the need to price our jobs higher when the labor hours are considered to be high.

'I once knew a contractor, who has since sold the business to a consolidator, and they priced their jobs the same way using the divisor method, and they did a ton of attic and duct jobs in their market, driving their mix farther and farther towards this type of work. Once day after a financial review, we discussed why dual overhead would charge a higher price, and the contractor said he might lose some of that work. He then realized he NEEDED to lose some of that work and mix in some higher margin replacement work, or raise his prices for the high labor type work. All along the contractor was underpricing the high labor work, the overhead costs kept rising, and it became a viscous circle. The more attic work he got, the less money he made at the price he was charging, because the overhead kept rising due to the longer hours it took to complete the hard attic installs. The realization that the competition was higher priced on these types of jobs, and frankly driving the work towards him finally got him to raise his prices, start using dual overhead, and start reviewing the work on the basis of how many gross profit dollars per hour it produced for the company (not many by the way compared to a replacement). He started filling the newly vacated labor hours with jobs offering higher margins, easier to complete and he made enough money to eventually sell the business!'

Now I am not suggesting you get rid of attic work, or cut-in return air grille jobs. You cannot serve your customers well by focusing on your profit needs. It is quite the opposite. You can however suggest to the homeowners that you move this work to off peak seasonal times when you need the work. You can even offer a discount for this kind of trade. This allows you to capture the higher margin work when it is available, and still serve your customer's needs.

Why is this critical to my success?

- Understanding the pricing systems of contracting make you more able to determine your own destiny.
- Making Dual Overhead part of your arsenal can help you attain more profits.
- Dual overhead can help you remain competitive at price points you may not have felt possible if you were using the divisor method, or the margin-markup method.
- Dual overhead allows you to identify breakeven easily on each job, allowing you to know job-by-job how to use pricing strategy, if you choose too!

Step by Step to Understanding and Implementing Residential Price Positioning Strategy

Pricing strategy is a critical success factor for all contractors!

Establishing the prices for your company's residential markets is important for a variety of reasons.

1. Proper pricing communicates value to customers.
2. Pricing allows you to make money.
3. Having a pricing strategy, including how you discount when necessary, allows maximization of profits for certain market segments.

Most of us understand the idea that a price is the starting point for a company sale, but how does strategy play a role? Let's review what a strategy is first.

Strategy is the overview of the entire process of selling a residential job, and using each of the pieces of the puzzle to work together to create a successful sale. It's the ability to install, the equipment, the price, the customers' needs and wants, your reputation, and many, many more factors.

So our price and how we decide as a company to "POSITION" our price, and various products makes a large impact on a potential customer. So we need to review this as a part of our big picture strategy. Here is an example:

Good	Better	Best
80% Gas Furnace	90% Gas Furnace	95% Gas Furnace
10 SEER A/C	12 SEER A/C	2 Speed 16 SEER A/C
3 Year Warranty	10 Year Warranty	10 Year Warranty
N/A	Maintenance Agreement	3 Year Maintenance Agreement
$3,100	$4,800	$5,900

This is simply an arbitrary example, with fake prices. However, you can see positioning at work.

80% of the customer in research studies about how customers buy choose the BEST VALUE! Which is that? That depends on your customer's wants and needs. Could be the good, the better or the best. That of course is sales process, which goes back to the pieces of the puzzle conversation.

7% buy for status, meaning the very best the industry has to offer, and the remaining 10% buy on price. So, is the positioning strategy above the right approach? Possibly?

Consider our own approach, which is a 5 tier strategy that contains something for everyone as a customer, and supports the notion that we know 80% buy the "Best Value", but we need to figure out what that is, and be certain that our own offer to customers meets their needs, and we can make money doing it, and we can satisfy the customer so we get a referral.

Basic	Standard	Deluxe	Premium	Superior
14 SEER A/C	15 SEER A/C	16 SEER A/C	16 2 stage A/C	21 – 2 Speed
80% Furnace	80% Furnace	80% Variable / 90STD	95% Standard	98% Variable
T87 T-Stat	Standard T-Stat	Programmable	Programmable	Upgrade Control
		Humidifier	Humidifier	Humidifier
		Standard Filter	IAQ Package	IAQ Package
			Source Removal	Source Removal
			Filtration	Filtration
			Air Purifier	Air Purifier
				Zoning Package
			2 Year Service Agreement	3 Year Service Agreement
			10 Year Warranty	10 Year Warranty
				IAQ Diagnostic
			Exclusive Customer Trust Guarantees	Exclusive Customer Trust Guarantees
$1,999 Promo?				
$4,999	**$5,899**	**$7,200**	**$10,100**	**$14,800**

All installs contain disconnect, wiring requirements, pad, line-set, indoor coil and the proper materials and quality checklists and install processes to get the job done right. Financing is always available to any option on the list. The always asked question – Why would you price a $1,999.00 system, and how can you do it for that? Answer, because:

1. It generates tremendous interest!

2. Of the 80 % best Value buyers – How many know what our value is? Not many? They are thinking HVAC total comfort systems should cost around $1,999.00, mistakenly of course, but we want to attract them knowing they will buy the best value system, if they only can be educated and make an informed choice. Left without the proper education, or to have a contractor who does not understand positioning strategy explain it to them, (meaning the job gets underpriced for the value provided); a consumer will buy the lower end of the spectrum. Properly educated customers virtually always choose a Deluxe or a Premium.

3. We rarely actually have a customer choose that system – A few a year do, but that isn't enough to create a market, or harm our reputation. In fact, we do a quality job. Remember, it is a vanilla system, and we use the lowest priced equipment, send our least productive and profitable crews, and we also explain to homeowner/renter this comes with no warranty other than the standard manufacturer's warranty.

4. We love the service after the sale – It can be profitable!

   Notice, no equipment brand is listed. We cannot install a premium brand for a Basic price. So the essence of positioning is to cover the range of options for your customers' needs and wants, then go about finding out what they actually do need and want in your sales process, and offer them the best value solution for them!

How do I setup my own price strategy and positioning?

For every market segment you do business in:

- Residential replacement and add-on.
- Demand Service
- Indoor Air Quality
- Maintenance Agreements

There is a pricing strategy that will work for you. You must decide what strategy to use based on your company characteristics, your goals, your desire to work, and what kind of company you are trying to create.

There are other factors that work in your favor or against you that you should address, so here are some steps to consider as you develop your strategy for price positioning in replacement:

1. Evaluate your market for competitors pricing – What and how they price.

2. Evaluate and know your own costs of doing business. You must understand your own financial structure and costs before you can set a price in any product or service.

3. Decide what kind of company you want to be – What are your goals? What are your production capabilities? What kind of work do you want to target? Pricing and positioning strategy makes a difference.

4. What kinds of products and positioning do your current equipment suppliers offer you? Do they have what you need to reach your goals? You may need to seek out different equipment brands or suppliers to achieve your company goals. Not every equipment manufacturer or supplier gets this concept, and remember they are building their products so they make money, not so you make money.

5. Once you determine what your company characteristics are, and how you believe the market is positioned, you are ready to begin establishing your pricing and product positioning.

6. Marry these areas together when you determine the company strategy and final prices.
   a. Your ability to communicate with customers.
   b. Your sales process ability to educate a customer well.
   c. Your questioning and evaluation process for customer's needs-wants-desires.
   d. Your installation prowess – A quality product.

e. Your current reputation and how customers perceive you today.

f. The company ability to install production – Are you a boutique company, or a mass production company – A positioning strategy like ours means less volume, more Premiums, so a higher gross profit dollar per man day, even though we could do more volume, we really don't want to do more volume.

g. Your company advertising and media strategy – Price communicates value. And $999 communicates a different message than $5800? Carefully think about how you will position your ads, because $999 also generates a bunch of leads?

h. Affiliations with retailers, such as Home Depot or SEARS need considered so your price positioning doesn't conflict with the retailers if you do their installs.

i. How you will create a value package of products and service bundled together to make-up a price point in your own chart. If you use a 3 tier, 4 tier or 5 tier strategy, what goes into these, how much do they cost you to put them in there, and what kind of gross profit dollars do you want out of a sale.

7. Establish your costs, your prices, and calculate standard GP$ on each positioning level.

Why is this critical to my success?

- Understanding the pricing systems of contracting make you more able to determine your own destiny.
- Understanding how to properly position your company against a competitor can help you compete against a price merchant (the low price contractor) or if you are the low price contractor, recognize there are other more profitable ways to make money by offering a variety of options to the homeowner.
- Understanding how people actually buy – That 80 % buy the best value, should lead you to consider the merits of figuring out what the best value is for your customers.
- When you arrive at a home and custom price a job one at a time, you have allow room for your own preconceived notions about what you "HEAR" from the customer to influence you. By having a preset number of positioned products, you are more able to focus on the customer's comments, and listen to where they fall in the position structure above. You can always discount off the price structure by removing options from the price positioning to create a custom version, this way your price has established a perceived value, and then if you remove zoning, or the IAQ package, you are not giving away your gross profit dollars, your removing value items from the package. This is very different than creating a price on the spot from a proposal, and then negotiating, because the customer has never seen the other value packages that are available, so they have a price in mind, is that $999, and your $4200 seems high? Having the positioning makes it easy for you to say, we can do $999 if that's what you really want, but in my questioning your answers indicated you wanted something different.
- A system of price positioning allows easier training for comfort advisors who one day may sell for your company. Tied to a discount policy, you have a controlled system of selling, which eliminates many unprofitable mistakes.

Step by Step to Understanding & Implementing A Price Discounting Strategy to Improve Profits

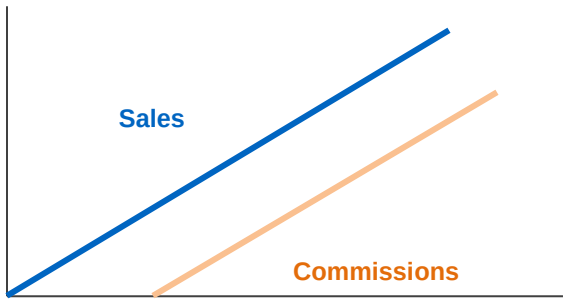
Discounting can be a strategy the supports profits, or destroys them for a company. A properly executed discounting strategy can be a lethal weapon!

Contractors know about discounts. Everywhere you go you here people complain about the pricing in our industry. How can I sell at a higher price when Joe's Heating is $500 beneath me and is selling the same product line? You hear it all the time!

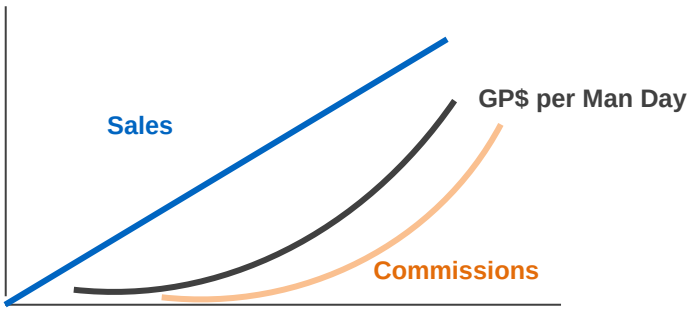
You also hear about contractors complaining about not making enough money, and when you want to discuss the selling process, that is the ability to communicate value for your products and services, you get a high level of resistance. No one wants to admit they are not selling well, or put another way, not using a disciplined strategy for discounting.

1. Many Contractors believe the MUST SELL EVERY JOB!
2. Many contractors have NO discipline in place for discounting, meaning the sale price declines, without reducing the products or services on that job.
3. Most contractors do NOT have any shared pain system of commissions or pay plans that align with the sales process. They use a straight line sales and commission system so any increase or decrease in sales means a linear relationship to both sales and commissions.
4. An aligned pay plan may reward a sales person for selling the right kind of jobs, high material low labor, as well as selling a type of job that increases the GP $ per man day such as a lower margin percentage job, but a higher gross profit dollar job with a hours that are the same to install!
   a. Increased commissions for higher GP $ per man day sales.
   b. Decreased commissions for lower GP $ per man day sales.

Standard Plan – Straight Line



Shared Gain and Pain Pay Plan



So in reality, discounting can be viewed as a two edged sword. The real trick for any service business is to create a reward system that pays the employees the best rewards for the production of the best gross profit dollars!

So the question becomes, how do we discount properly, and with the disciplines we need to maintain our profits, and not fall on our sword?

Let us start with the basics.

Improper discounting is when you reduce price without reducing the costs in line with the price reduction.

1. Discounting improperly can affect many areas.
   a. Your profits – By giving away margin dollars.
   b. Your reputation – Other neighbors may benchmark off that price.
   c. More profits goes away – If you pay a straight commission rate – as the sales price drops and the margin drops, the sale person still may get paid a flat percentage of sales, and has no incentive to sell up above and create value for the customer.

2. Sales behavior is consistent in that given the opportunity to discount the price, the sales pattern is to take the path of least resistance and do so!

   Proper discounting is when we reduce the price in systematic progressions, under control of the sales manager, and the reward plan reduces the commission percentage on sales as the discount levels increase.

   - 8% commission on sales at $5,000 job price = $ 400 commission at 45% margin of $2,250.
   - 5% commission on sales at $4,750 job price = $ 237 commission at 40% margin of $2,000.
   - 3% commission on sales at $4,300 job price = $ 129 commission at 36% margin of $ 1,550.
   - 1% commission on sales at $4,200 job price = $ 42 commission at 35% margin of $1,450.

As you can see, when the price goes down, the margin declines, and the discount is declining. This is under the assumption that the sales person is paid on sales, and that no reduction in products and services has occurred for the discount.

Paying on the gross profit margin of the job, specifically the gross margin dollars per man day, is a much fairer way to pay the sales personnel, and although the sales personnel may not like the idea due to their inability to control labor on the job. However, they do control the estimate of labor hours, and the price!

- 18% commission on GP at $5,000 job price = 45% margin of $2,250 = $ 405 commission.
- 15% commission on GP at $4,750 job price = 43% margin of $2,042 = $ 306 commission.
- 8% commission on GP at $4,300 job price = 40% margin of $1,740 = $ 139 commission.
- 4% commission on GP at $4,200 job price = 39% margin of $1,638 = $ 65 commission.

Notice the commissions are paid on GP $, and we have not discounted without removing certain products or service costs inside of the job, to hold-up the margin at the same sales prices in our first example.

Implementing and Establishing a Profitable Discounting Strategy

1. Determine your price positioning strategy – How you plan to sell the products in your company.
2. Once you have your positioning strategy, you need to establish your costs to complete the jobs on an average basis.
3. The job costs can then be translated into prices, using dual overhead, divisor, markup factors on costs, or some other pricing system.
4. Once the prices are established, a discount strategy can be applied. We recommend three discount levels. Retail, drop 1, drop 2, and the bottom line sale price.
5. A commission factor needs to be assigned against each of the price levels for the job, either on sales, gross profits, net profit, or some combination of the three. We recommend sales because it is the easiest to understand and reduces administrations costs due to its ease to calculate.
6. In any case, the commission factor needs to be added on the back end of the job price, so as to insure the margins of the company based on the levels of discounts remain consistent!
7. There should be a bottom line sale price, which can only be changed by approval of the sales management function of the company.

Recap to proper discounting strategy!

Discounting is a two edged sword that can be an effective weapon, or the death of your profits!

1. *Contractors need a disciplined approach to discounting.*
2. *Discounts should be granted with reductions in products and services, not just a reduction in sale price.*
3. *Discounting should have aligned rewards, so compensation is tied to a sliding scale of gross profits, And/or sales, preferably based on the gross profit dollars per man day.*
4. *Discounting can only be allowed to the bottom line sale price, without approval from the controlling person for gross margins in the company!*

Why is establishing a discount strategy critical to your success?

- Discount strategy needs to be controlled.
- Discount strategy should be organized and disciplined.
- The company should have assigned accountability for discounting to occur beyond the bottom line sale price.
- **Proper discounting will help you make more Profits!**

Step by Step to Understanding How to Set Prices Involving Your Company Personnel to Create Maximum Buy-In

Establishing buy-in is a key to improving company profitability!

Creating buy-in can be a tricky concept if it is not well thought-out. It requires an owner/manager to understand how to manage the processes of:

1. Setting pricing well enough to teach the process to employees.
2. Working with employees to educate them on understanding their role in the price.

Creating employee buy-in can be very slow and difficult, but it also can be a rewarding process as well. There are many companies that have achieved higher margins due to the fact that the installers, and the sales team have actually worked together with the owner/manager to set the company residential pricing.

And the Service Manager, or service technicians have worked in a similar fashion to set the labor rate, the diagnostic rate on Flat Rate, and even the task times for Flat Rate.

All of this comes down to one simple concept:

Allowing your employees to have a chance to influence their own destiny.

The idea of creating buy-in takes hard work if it is to be executed well. Imagine the installer who is struggling to meet a labor target that is set at 9% or a replacement job price. He wonders why he is accountable for this, and believes the company is making way too much money off his labor, and feels it is unfair that the company isn't sharing more of this profit with him, by paying him a higher wage. Several outcomes are possible here, none of which are good for the company:

1. The installer drags out the job to capture more hours (Hutchinson' Law).

2. The installer complains to others about his plight.
3. The installer leaves for a .50 cent and hour raise.

The bottom line is this installer situation happens regularly, and it stems from the lack of buy-in about:

1. The hours allocated to the work – Hours to complete the install.
2. The company's need to have the labor costs maintained at 9% or below on the retrofit job.
3. Compensation systems that are ill designed and sometimes simply not understood buy the installers.

Many contractors simply DO NOT Want to hear this! They believe buy-in means opening a can of worms. Perhaps? Yet if the worms are there, why are they there? How committed is that employee to your organization if there are worms in the can?

The reality is there is a fear here, and it is on both sides of the equation. The owner's fear of not being capable of explaining the pricing, the labor tasks, and aligning compensation systems with company pricing, and of course the fear of the employees to communicate with the owner about their concerns. The employee will complain to their peers but not always to the owner (this is another issue).

The good news is this can be overcome!

To be successful in the current environment, employers need to learn to communicate, and involve their personnel. We call this persuasion through involvement. It is not about changing the owners ideas, but instead actually getting the employees to see the wisdom behind the ideas, in this case prices that make money, educating the employees about who, what, when, where, why and how.

Follow these steps to creating buy-in!

1. Define the idea you are talking about – Creating residential prices.

2. Once the idea is defined, decide who in the company this affects (Sales, Installation).

3. Map out on a piece of paper and outline of what concerns you believe the employees will have when it comes to having a residential pricing plan established at the margins you desire (45%).

4. Set a meeting and prepare an agenda for this meeting with these employees.

5. The agenda should ask the employees to come prepared to discuss their ideas of how to best create a residential pricing plan.

6. You need to be prepared to train the employees in this meeting about "How prices are created" meaning what are the job costs, what are the charts of accounts on a profit and loss statement, and where each of these

employees fits. Clearly sales commission affects the company's price, as does the labor costs for the job (meaning labor hours).

7. After you have trained the employees in this meeting, you have a set of objectives. How do we set the hours for the job to be fair to you, and thus completing the work in an appropriate time, but still allowing the installers the opportunity to say, yes, we can do this? We may need these tools, but we can do it.

8. The feedback you get may enlighten the company about new ways to complete the work, new ideas, innovations, or any way to say, we can meet the hours. The absence of this feedback limits the ideas from the people who actually do the work.

9. Conduct the meeting and solicit the feedback, remember all ideas are good ideas, and your role is designed to foster input, teach, train, and be supportive. If this is the first time for you to do this, be certain to let the team know, it's your first time.

10. Write down the feedback, and listen carefully. The examples above may be the installers will agree to do the work in the time they committed to; they will understand the company needs the labor percentage to be at 9% of the sale price because you trained them on the profit and loss statement. Your pay plans may need to be adjusted. If I finish the job ahead of schedule, and do it well, will you share the savings with the installers?

11. In the end, you can then feel good that you have a team of personnel, sales and installers that have had the opportunity to influence their destiny, they will feel good, and they can have a good understanding of how and why you are paying them this way. The company only makes money to afford their pay bonuses if in fact the labor percentage comes in at or near the 9% of sales.

Why is this critical to my success?

- Having employees that are bought-in creates alignment, and means the employees are focused on the work, and not the act the company is making money off their low wage, or their sweat.
- Having employees that buy-in creates a culture of trust. If you have used the employee's ideas, they feel you will listen to them, especially if they have issues.
- Having buy-in creates focus on the tasks at hand, improving focus on customer service and completing the work in a quality manner.
- Having a sales team that got to help create the prices allows them to understand how prices are set, and that as they discount, their compensation also gets reduced. A declining sales price reduces the company margins, so the sales team needs to realize this through your Profit and Loss training, and understand how important it is for them to sell at the desired margins, or forfeit some of their commissions to offset the company loss of margin.

- Buy-in is a leadership tenant, and it helps the leader, be it an owner, or a manager in the company, communicate with the employees to be certain everyone has the chance to voice an opinion, an idea, and perhaps an innovative method to help the company.
- **Buy-in helps you make more profits!**

Step by Step to Understanding & Implementing
The Communication of Value in the Replacement Market as it Applies to Pricing

Residential Replacement is one of the most lucrative markets in our industry, yet many contractors underprice this market!

1. They do not understand their costs.
2. They do not effectively communicate the value they offer.

Most contractors in the HVAC industry are involved in the replacement market in some manner or another. It can, and should be the single most profitable market we do business in, yet you will often hear contractors complaining about the guy over there that muddies the market with low prices, and he'll probably will go out of business soon! He's killing my profits! I can't make money with him screwing up the market!

Sometimes they do go out of business and sometime they do not! In many cases the contractor being described above is simply working for day labor wages on any job they price and install, and that suits him perfectly fine. By the way, they are NOT going to go away. A new one always takes their place!

So both issues are in play:

1. That contractor does NOT understand costs or he chooses to ignore the fact that he deserves a salary as an owner and should be making 15% profit AFTER he pays himself a salary. Meaning he is cheating on his overhead burden (cheating himself).
2. If this guy bothers you, your company MAY NOT GET IT when it comes to separating yourself from this type of contracting firm, and creating perceived value to the buyer.

So we are dealing with two issues, the need to get the costs and margins correct to meet your company needs, and the need to establish value!

What is value and how do we communicate what value is to our customers?

Value is when the perceived benefits that a person gets exceed their belief about what those benefits should cost. There lies both the opportunity and the problem. Let us explain.

If we can get someone to believe that our wonderful HVAC home comfort system. Is worth more than the price they are paying, we will have a great shot at getting the sale!

If someone has a predetermined attitude, or (Another BID – Beat Idiots Deal) then we have some work to do to establish why our home comfort system price is justified compared to our friend.

So, we have just formed the basis for the discussion of "How" we do this? Call it marketing, selling process, persuasion, manipulation, capitulation or whatever, the bottom line here is we must earn the customers trust that our benefits to them are worth more than our price.

How do people perceive value?

That question is simply answered – All differently! When I was in college and was looking at purchasing my first car, I wanted to buy a 1969 Camaro. I saw great value in such an automobile. It was a cool looking car, fast, and would help me draw the CHICKS! My father on the other hand, thought the best value on the market then was Chevrolet Chevrolet. Are you Kidding I exclaimed? What would I do in a Chevrolet? Not the chick thing for sure!

It's a true story, and it does illustrate several key points about value and the lessons we take away from each point for your selling and pricing process:

1. Value is part of a belief system each person holds near and dear to their hearts.

   The lesson is you must discover through questioning what the beliefs are, and if there is more than one person in the buying equation, who they are and what their beliefs are. We do this through questioning skills and listening skills.

2. Value perception is highly personal – Highly emotional and highly logical (both) – Depending upon the personality we are doing business with – We have to decide and sometimes it can be both at the same time (See above).

   The lesson is you must discover understand who the decision maker is, and also if there are people that may influence the process. My father was an influencer, and a very powerful one at that due the deep respect I have for him. He was not paying, but I also did not want to disappoint him. Which emotional or logical beliefs and wants will win out. You must determine what the homeowner's needs, wants and desires are, and find out how strongly they believe in each of these.

3. Value is established by how we see the benefits making us look and feel – In my Chevrolet I felt Chick Challenged! In my Camaro, despite my unruly college look, big nose, short body, and no money – I was going to be a Chick Magnet! The value is what the person believes the benefits will do for them.

   The lesson is learning as much as you can about how people perceive the product and service being used. Use projection, how do you see yourself using the new home comfort system? Imagine you had a top of the line, how can you see this benefiting you? I saw Girls everywhere in my new Camaro. I saw no Girls with my Chevrolet. Products and services are part of who we become – Yes even heating and air conditioning! Not

everyone, but some people are very proud of their new systems. Find out. Ask the right kind of questions and pay attention to the values, the needs, and the wants, and the desires.

4. Value can often have some logical benefits that tie into the decision making process and these need to be clearly identified and ranked. The ranking is very important in case we have to reduce price later to meet a budget, we know what to remove, and it is doubly important that the customer does the ranking. It's hard to resist your own ideas!

   The lesson is to determine what the logical side of the buying decision is as well as the emotional. I needed a car! I was buying a car! It is transportation and I had a definite need. So the only question was how was the need going to be solved? In home comfort, customers have needs. Find out what they are and rank them by priority. The room doesn't cool properly. Gas bills are too high. The thing always breaks at the beginning of winter. These needs will be translated into solutions at some point, but everyone has their own set of needs and you CANNOT MAKE ASSUMPTIONS BECAAUSE YOU THINK YOU ARE AN EXPERT! Be an expert on you and no one else. Make no assumptions about what I need. I needed the CHICKS! DAD grew up in the depression and he needed prudent use of money.

   - **Lesson # 1** – Peoples history makes them who they are today – All of those experiences have gone into shaping the values and beliefs we hold near and dear to our hearts. Find out whom the people are and where they have come from and it will enlighten you not only about what questions to ask, but what the beliefs are about "VALUE".

   - **Lesson # 2** – If the buyer has logic – Explore the financial aspects of the benefits as well because there may be a story to tell about investment return, payback time, or why its mathematically a better deal due to your special promotion or rebate.

5. Value always has a place between a price merchant and a high-end merchant and everything in between. Left alone without any indication of why the benefits are important to me, the lowest common denominator is always going to be low price. Even wealthy people will react this way. The only crowd that doesn't is the status buyers who represent 7% of the US population. 83% want the best value, and 10% are price shoppers.

   The lesson is to determine what type of buyer you have? 10/7/83 or some combination of the above like my father and I. Husbands and wives are not created equal. Everyone knows the wife is superior, and she most likely is a strong influencer if not the PRIMARY Decision maker in the home. If you do not communicate what the benefits are, and more importantly why the benefits meet the needs, wants and desires of the customer, we are going to be buying a low cost home comfort system that meets our needs as far as we know what they are.

   - **Lesson # 1** – The customer doesn't always know what their needs are. We cannot assume they know. This is why you need a process, and you have to stick to the process, when asking high gain questions and determining with your customers what the needs really are? There are many cool accessories to my Camaro that I didn't even know about until later. Home comfort advisors should remember to use a process that walks people through each phase of what we do, and ask the questions, and listen. We have to educate customers, and that is the bottom line, so how are you going to do this?

6. Value shifts with trust!

   Funny thing about value, when you lose the customers trust, or you never gained the customer trust to begin with, value gets shifted aside. I had tremendous value in that Camaro, but never once did I get my dad's buy-in that it was necessary. We had a values and beliefs clash as many families do. So remember, when working with HVAC comfort systems in the home, you cannot establish value when trust is blocking all forms of communication.

   Remember good communication is when both parties understand and agree. When trust issues are blocking the way, no value communication is being heard.

   Therefore everything you are saying is going to be pushed aside when the next bidder comes in and does establish trust, and unlocks they keys to the value conversation..

   (By the way, I bought the Chevrolet. The key influencer won out. It usually works this way. Research suggests about 95% of the time (Read wife/spouse). Later though, when out of college I bought a shiny new red sports car (I knew I was right all along).

Some Considerations for Establishing Value:

1. Determine what makes you different from your competition!
2. Determine why a customer would lose out if you went away tomorrow.
3. What do your customers want and ask you for you do not provide?
4. Cancel low price with extra value in products/services, and use your marketing materials to highlight these areas of deficiency in the competition. We use a detailed work specification asking low price bidders to meet our work specification – They can't at their price.
5. Provide personal services to your customers.
6. Educate your customers well – Use good techniques and good materials to help you do so.
7. What additional needs can you fill for your customers?
8. Define your sales processes and pricing practices, and make sure they match so you are not a high priced poorly trusted company (they are out there)!
9. Define your market segments and know what target customers fall into those segments (Read into this you need a tiered product strategy).
10. Bundle your products and services together, and offer special high value bundles that match-up with your customers' needs, wants & desires.
11. Offer guarantees and warranties on your positioning of certain products and services that make it difficult for the customer to not see a minimal risk.

12. Be capable of justifying your quality – Not just talk – But real life justification such as digital images, credibility booklets, testimonials, video of quality process of installations.
13. Market to your existing customers more – They should already know you are a GREAT Value for them, and they will refer you when they can.
14. Control your discounting activities. Discounting sends the signal that the price is not greater than the value. We will only discount 5-10% and only do it if the customer is willing to sign right now for the investment agreement.
15. Study the competition for ideas they are using, and learn about their strengths and weaknesses.

The entire basis for communicating value through pricing is this; you must convince your customers the price you are asking for is less than the value they get from you. Remember if value weren't important to us, we wouldn't have bottled water!

How do we use the concept of residential pricing?

a. Learn to set a positioning strategy in place, where customers have choices to make, and you can make money on any of these choices, but especially the higher end products.

b. Learn to bundle your products and service. On the higher end products, add a service agreement, and an extended warranty to the product bundle. This improves the positioning, meaning it creates uniqueness, and separation from the other offerings you are making.
   - Service Agreements
   - Extended Warranties
   - Duct Cleaning, Accessories
   - IAQ Products
   - New Thermostats
   - Upgraded Ducting Systems

c. Consumers will choose buy these criteria:
   - 10% Choose on Price
   - 83% Choose Best Value
   - 7% Status – The Best

   Based on this study data, why wouldn't you offer a few value-based options knowing that most customers are buying what they perceive to be the very best value for them.

d. Consider how you are going to communicate the value-price relationships.

e. Establish sales training that supports the concepts in this article.

f. Establish marketing materials that support the concepts you want to communicate.

Why is this critical to your success?

- Residential pricing in the replacement market is one of the most important areas of our business.
- Being able to establish value is crucial, as you will face the price merchant every day, sometimes 5 times in a day, so you need to be able to effectively deal with them.
- Contractors who want to train others to sell for them instead of doing all their own selling need to understand the value process, and decide what training systems and materials they need to become process oriented for their training.
- The contractor that cannot communicate value is forced into a discounting role, and this usually at the sacrifice of profits. A contractor that can effectively communicate value has the advantage.
- **Proper pricing systems and proper communication of value offer you a great chance at making double-digit profits and definitely will help you make more Profits & STAY OUT OF TROUBLE!**

Step by Step to Understanding and Implementing a Service Labor Rate

Establishing a Service Labor Rate is essential to profitability in the service department!

Whether you are on time and material, or Flat Rate pricing, your company must know what its base labor rate needs to be in order to recover the costs in the service department. Many companies are not departmentalized in their overhead, and some not even to their gross margins. No matter, the service labor rate needs to be calculated to insure the costs of doing business in service is properly established.

Facts:

1. Most HVAC companies are losing money in service and do NOT Know it!
2. Most HVAC companies are fearful of raising their service rates in fear they may lose customer.

Follow these steps to creating establishing service labor rate:

1. The easy way is to divide your average service direct labor cost with benefits (Adding up all your service labor hours paid, and dividing by service payroll to get an average cost per service labor hour) let's just say $20.00 per hour, and then dividing by the ratio of 22% (the labor standard for service in our industry) which is equal to $90.90 or call it $91.00 per hour.
2. A contractor must determine how they are going to position this labor rate. Are they charging a diagnostic fee to travel to the home and diagnose the trouble? This is a common pricing component in a Flat Rate system. Are they going to charge by the ¼ hour, or the ½ hour, the diagnostic and the ½ hour, or are they going to get on Flat Rate which charges by the task and the amount of labor time it takes for the task? There are myriad ways

to charge for service, but in the end it is all about whether you have your base labor rate set correctly to cover your costs.

3. Each quarter, check your average labor cost per hour. Overtime, and a labor force that is dragging out calls due to poor training or skills, or simply a new technician or two can change the way the labor per hour cost is occurring in the company. We are not suggesting you change your rates quarterly, but if you hired two new technicians because you needed one, and another quality technician of yours retired or left, the direct labor cost per hour could have climbed to 22.00 per hour, leaving the company service labor margin in decline at a base labor rate price of 91.00, as the new rate should be $100. If the quarterly rate has changed drastically, you may need to adjust your price. By the way, the average base labor rate in the industry is right at $110 per hour.

4. Remember, this is strictly the base labor rate. Not the parts markups or any other price.

$$\frac{\text{Total Service Labor Dollars Paid (Labor Only)}}{\text{Total Labor Hours Paid to Service Labor Only}} = \textbf{Effective Service Labor Cost per Hour}$$

$$\frac{\text{Effective Service Labor Cost per Hour}}{.22} = \textbf{Street Labor}$$

Why is this critical to my success?

- Having your labor sales separated from your parts sales tells you whether your labor costs are climbing and why.
- Creating a street labor rate that covers your costs is crucial to service department profitability.
- Knowing and understanding your service department labor rate is important for the service manager to be sure any new technicians, or new hires are monitored to determine any loss in productivity, so any street labor rate adjustments can be made.
- **Setting a proper street labor rate helps you make more profits!**

Step by Step to Understanding and Implementing Flat Rate Service Pricing

Flat Rate pricing for HVAC contractors is good for some, not good for others, depending upon whether your company is ready to implement Flat Rate!

Flat rate pricing is a system of pricing whose time has long since arrived in the HVAC industry, and whether you are one of the many thousands of contractors who have made the switch, or are among the thousands who have not, please consider the following ideas as you move forward in your contracting life.

Flat Rate is an excellent system of pricing. So too is ***"Time and Material"*** pricing an excellent system. Each has its own unique strengths and weaknesses, the most important of which, is whether or not the contracting company moving to Flat Rate is capable of implementing the new system of pricing that requires a very different set of skills than a "Time and Material" pricing system.

What can happen?

1. There are many contractors who have made the switch to Flat rate very successfully.
2. There are some who survived the switch to Flat Rate, having had problems then emerged for the better.
3. Still others have implemented flat rate, and it has costs them their profitability.

Let us not be alarmist in any way. The differences between those contractors' in-group 1 above and in-group 2 or 3 are centered on how well they were prepared to make the transition to a new system of pricing.

The best and preferred method of pricing in our service industry is FLAT RATE! You simply must know how to implement, train, follow-up, maintain labor control, and understand how the system works to make Flat Rate work for both you and the customers.

Advantages of Flat Rate:

1. Can be made very simple for technicians to use, easing the technicians burden.
2. Technicians communicate the price to homeowners before the work is performed, making homeowners happy to have a locked in price.
3. Customers no longer pay for your inefficiencies, insuring the customer will not be unhappy about the price.
4. Easier to sell maintenance agreements using Flat Rate systems, due to the built in price positioning strategy a Flat Rate System offers.
5. More professional look, approach to homeowner enhancing the image of the company and the technician.
6. Task times being clearly defined; allow training insights to technician's individual training needs.

7. Allows for marketing bundles such as “No overtime” as the overtime hours and costs are estimated and become part of the base labor rate, spread over all service calls a little at a time.

Weaknesses of Flat Rate

1. Labor control and understanding how to keep close control over the service labor percentages are a need more than a weakness, but in the absence of the capability to watch labor on a daily, weekly and monthly basis by technician, it can be major obstacle.
2. A contractor with newer, less experienced technicians may lose productivity, and profitability due to the new technicians not meeting the assigned labor task times on service calls.
3. Any inefficiency costs the company not the customer. This means the contractor needs to monitor the on-going technician productivity (by individual technician) or face possible loss of productivity and profits.
4. Flat Rate requires a contractor to pay attention to labor as a percent of service labor only sales to be sure task times are in line with the estimated task times for the Flat Rate price.
5. Assigned labor task times should be reviewed and monitored constantly (monthly) to insure they are being consistently met.

The Basics of Flat Rate Pricing

Flat Rate is a system of pricing that establishes a price that is fixed by each task performed in service, such as a gas valve replacement. This price is fixed for the activity, no matter how long the service call takes, or how many visits to the home or supplier it takes. The only exception is designated special order inventory items.

In calculating a Flat Rate Price we use:

1. A parts cost, and a series of parts multipliers based on the part cost, to arrive at a part retail price.
2. A materials list/costs for the activity, and a multiplier on material to determine the price of materials.
3. We use a sales tax multiplier for each state to determine the sales tax for our parts & materials.
4. We use a base retail labor rate and multiply this labor task time to create a retail labor only price.
5. We also have a diagnostic charge, (say $49.00) applied to every service call for the initial diagnosis of the home.
6. In many cases, we have 3 variations of the labor only price for price strategy purposes. An example is a standard price for new demand service customers, a discounted price for service agreement customers (preferred price), and perhaps a third price for ELITE Customers (those who may have purchased a top of the line system and a service agreement.

The diagnostic labor price is based on our base labor rate, and covers the trip out to the home, plus a task time for diagnosing the customer’s technical problem. Typically the diagnostic is NOT waived even if the customer chooses not to have us perform the work due to the time of travel, and the diagnostic time used on the job.

(Refer to the EXCEL spreadsheet on calculating a Flat Rate Repair)

A price is chosen from a book that contains the various tasks. On a typical invoice, there may be more than one task that is listed by the service technician. These are listed out for the homeowner and before any work is started, the customer will approve the work.

At the end of the process, the customer will again sign-off on the work performed, and if they DO NOT own a service agreement, the technician will offer them a discounted Flat Rate price as described above if they sign-onto a service agreement today (The customer would have to pay up front for the additional service agreement price). If the customer declines, a box is signed on the service invoice clearly stating the homeowner past up a discounted amount.

Invoice Total Today	**$400**
Total Service Agreement Savings (15% discount on labor)	**$60**
Invoice total with a Service Agreement	**$340**

STOP: **Customer initials Declining Savings** [ ]

Total Service Invoice

$340

If the homeowner chooses a service agreement discount, the technician would complete the service agreement and collect a second check for the amount of the service agreement, in addition to the service invoice check for $ 340.

Some keys to consider before switching to Flat Rate:

1. Are you prepared with a technician training for the Flat Rate System?
2. Is your vendor prepared to support your needs after the initial Flat Rate training?
3. Do you have written service technician procedures for how to write out a service ticket on Flat Rate?
4. Do you have service technician procedures written out detailing how to sell a maintenance agreement, precision tune-up agreement, or price a service call to a customer who has a preventative maintenance agreement?
5. Can you determine the labor percentage of demand service sales, by technician and for the total service department by day, and by week? If not, you may incur an increase in labor costs when you stop billing for your

time that is inefficient, even though you will increase you base labor rate to accept some inefficiency, it will still be an issue that needs watched very carefully.

6. Will your customer like the system better than time and material?
7. Will your technicians like the system better than time and material?
8. What type of service management function do you have, and is the function capable of creating a plan to implement Flat Rate, and executing the plan well.
9. What time frame will you use to make the switch to Flat Rate? Timing can be important to allow for training to occur in slower, non-peak periods.

Follow these steps to creating a Flat Rate Pricing System:

1. Determine the parts markup multipliers for the value of the costs of the part. What ranges will you want to use for the costs of certain parts?
2. Determine the sales tax for the parts/materials in the state you live in.
3. Determine the base labor rate for your company hourly labor rate. Calculate the average hourly rate of pay in your service department labor payroll, and divide by .22 (Industry Benchmark) to create a labor rate. The multiplier yields a gross margin in the range we desire.
4. Determine the diagnostic fee (trip time in hours, plus 30 minutes diagnosis time) is for your Flat Rate pricing. Use the time for the travel and the diagnosis, and calculate the price for the diagnostic fee.
5. Meet with your technicians and determine the tasks they have in the business, and the average task time it takes to complete the actual work. Do NOT include the diagnosis here.
6. For each task time and activity, define what parts and materials will need to accompany the task for service.
7. Once the technicians have agreed upon the task times, and the parts/materials to conduct the work, a price can now be established. Follow the worksheet on Flat Rate pricing for each task.
8. Develop your Flat Rate manual – Either use a vendor's material, or use your own. An EXCEL Template is provided with sample Flat Rate pricing system.
9. Train your technicians. The service manager or owner should conduct the 1st class. It should focus on the basics of how to create an invoice, using the Flat Rate manual, and how the system works. How to use the invoice, the clipboard, the pages, the diagnostic and a question and answer session.
10. All policies of how Flat Rate is discounted, what to do with service agreement customers, how to bring on new service agreement customers should be handed out and communicated in writing, so technicians can refer to the materials.

11. Have the successful technician conduct the second training class, and as the 1st month of implementation goes by, have the service management function work directly with those technicians having difficulty.
12. Avoid any technicians being allowed to create their own prices due to lack of information or tasks.
13. Have in place a system of capturing bad task times, or any new tasks that were missed.
14. Conduct follow-up training using the technician-training manual.

Why is this critical to my success?

- Flat Rate pricing is a system of pricing that is customer friendly and can win over more demand service customers.
- Involving your team, your technicians in the development of the Flat Rate task times and activities, will create much more buy-in and ultimately use of the system.
- Flat Rate pricing is a great tool for use in service marketing, helping to position your company in a manner that supports customer focus.
- Your technicians will need trained, but once they have been trained well enough to be comfortable using the system, they will be happier and more productive due to the lack of customer complaints.
- **Properly implemented Flat Rate Pricing will help you make MORE PROFITS!**

Step by Step to Understanding and Implementing a Service Pricing Market Analysis – Benchmarking Prices in Service

Establishing service labor only prices and your possible Flat Rate labor rate is best performed after you have gauged the market prices, as a prelude to setting your own price to market!

Rule number 1 of pricing is to always price to the value proposition that you offer. Meaning simply, you have to set the price based on what people will pay for, and what you as a company can realistically expect to charge and still make a profit.

This can mean a higher than average market price, or lower than average, but in either case, your prices should reflect the need attain a gross margin level allowing the company to cover the overhead costs (S.G.&A.) and attain a reasonable profit.

1. This implies you know the markets reasonable envelope for price ranges and are comfortable understanding the range, whether your company has to be higher or lower than the range.
2. It implies you have enough financial structure to know and understand your service costs to the level of breaking down service labor only sales revenues, and separating parts sales from the total service sales.

3. It implies that you are productive in your service operation, at least enough to make money at a level keeping your labor costs under control (22% of sales is the labor only target) and your SG&A low enough that you make a profit in service at the price you establish.

4. It also implies you can communicate the value you offer in your services to the homeowner such as charging $100 per hour, for 24 hour, 7 day a week, 365 day a year service done in a professional, quality, and craftsman like manner. This $100 may be the highest in the market, or it may be in the middle, the issue is whether your customers are feeling that you delivered the value for the price and continue to trust your company services!

There are some contractors do not understand the concept of evaluating the market to establish a competitive benchmark before they set their company service labor price.

Benchmarking price is NOT the determining factor! It is a contributing factor.

The most profitable companies benchmark the competitive landscape for prices on a regular basis. This means in the spring, and again in the fall. Two times a year the evaluation of ALL competitors is necessary.

If you benchmark just those who you believe to be the closest competitors, you run the risk of not having a clear idea of the overall market. The second issue is since our industry average profit level is 2%, it is a safe bet at least some of the market competitors have **NO IDEA** how to price their service and do NOT handle items 1-4 in this article well enough to use ONLY their data to help us evaluate.

We must have the entire picture, and then we use the data to support conclusions, not invent conclusions!

Follow these steps to successful benchmarking for service rates:

1. Establish financial structure in the company to know the labor only sales and the parts only sales in the service department.

2. Determine the labor cost (excluding burden of benefits for direct labor costs) – The target for service is 22% of labor sales.

3. Organize a form to use and train a person to contact each competitor. The form should be a script to follow, so information can be gained in a consistent manner, and a complete and thorough benchmarking can be accomplished.

4. Choose the individual to conduct the calls to the market competitors, and train them on how to use the script. The scenario you use for the script should be real for the time of year and market your company is in, and it needs to be followed to get data that can be compared.

5. Utilize a spread sheet, or some form of a matrix with all the market competitors listed on the form, and have the spread sheet price organized to accepts a variety of price variations, understanding that some companies are using a Flat Rate system of pricing, others use time and material, others use some SWAG methods, so there are numerous forms of pricing that need to be collected, and tabulated in a manner which you can use to compare - Such factors could be:
    a. Flat Rate diagnostic charge fee to come to home.
    b. Flat Rate labor rate to fix a repair like a gas valve – Honeywell V800.
    c. Costs to travel to your home.
    d. Costs to of labor to diagnose the system repair.
    e. The cost to have technician repair a defective gas valve – The service repair labor, and the gas valve repair price.
    f. Overtime costs if any are possible.
    g. Does the company offer any service agreements?
    h. Do you get a discount of you are a service agreement customer.

Once the calls and role play has been made to all competitors, you can then take the information that is now laid out on the spread sheet, and begin evaluating how the market is pricing service, and even parts.

We can put the data into a labor rate per hour format. We can also put the markup factor for each company for the gas valve, since most everyone buys the v800 valve at a similar price in the market.

Evaluate the data to determine how your company stacks-up. Are you LOW? Mid-range? High?

As we evaluate our company position in the market range, we should now begin to carefully consider how we WANT to be perceived in the market. Customer do call around, so the same information we have, will be used by consumers to form perceptions about who we are as a company, so remember, the low and the high segments are smaller portions of the overall market.

Evaluate your value proposition – What you offer and why; then set your price for labor.

Why is this critical to my success?

- Benchmarking pricing is a system of gathering competitive data for service labor, and also service agreements, that allow you to fully understand the range in the market, and helps you gauge whether you are inside the reasonable envelope on the high and low end of price.
- Most contractors are priced too low in service for their level of productivity. Meaning the vast majority of contractors do not control their service labor costs, by not getting enough revenue and gross margin dollar production from the service technicians, combined with a lack of labor control, this creates a profit problem. Benchmarking helps you identify where your company price is relative to the market, and is one more indicator

for you that you may not be productive if you have to raise your labor only rate too high for the market place.

- Benchmarking keeps you focused on market and the possibility of raising your labor rates so when a competitor raises them, it may offer you an opportunity to also raise your labor rate.
- You may identify your labor rate is too low based on your costs, your efficiency, productivity, and labor controls, which means benchmarking can focus you on the proper ranges to be targeting.
- Benchmarking lets you know you are priced accurately to your value proposition. If you want to be the higher priced value added service company, you'll know it! the lack of customer complaints.
- **Properly benchmarked Service Labor Rates will help you make MORE PROFITS!**