



Bulletin

Service Mark-ups vs. Construction Mark-ups

Introduction

By definition, a "mark-up is an amount of money, stated in either dollars or a percentage, that is added to your cost."

<http://www.merriam-webster.com/dictionary/mark%20up>

The mark-up serves several functions by providing:

- funds to cover **overhead** costs
- a fair and reasonable **profit**
- some cushion in case **estimated costs** are exceeded. This factor will vary based on **risk**

The following describes the components of each function and then discusses potential elements of a job estimate that may be considered for mark-up.

Overhead

Overhead (OH) originally meant "what's OVER your HEAD," or in other words, YOUR ROOF or your office space. In our industry, we have two streams of cost: *Direct Job Costs* (DJC) and *Indirect Costs* that cannot easily be allocated directly to any particular project (i.e., overhead).

Construction Contractor's Overhead:

Every contractor's OH will vary depending on how their business is structured and by their volume of work. For example, suppose there are five

people in your office space, who generate a total of \$200,000 per year in total "overhead" costs covering wages/fringes/taxes/rent/utilities etc. If you bill-out a total of \$1 million this year, your OH costs would be 20 per cent of your sales. But, perhaps you could do \$2 million in sales with the same size office and staff. Now your OH is only 10 per cent of your sales. Your DJC increases in direct proportion to the volume of work incurred, but your OH does not. The more dollar volume of work you do, without increasing your OH, actually drives your OH down as a percentage of your sales. However, as your sales increase, you WILL reach a point where you will have to increase your OH and that changes the equation again.

Service Contractor's Overhead:

Service work normally calls for a higher percentage of OH than construction work. Aside from the high DJC of labor, fringes, taxes, trucks, uniforms etc., a service technician requires a lot of office support. The costs for handling customer calls, dispatch, billing, paperwork, callbacks and other non-billable time should be considered in determining a mark-up.

Profit

Profit is what remains after all the DJC's are paid, the OH is paid and the revenue

comes in from the customer actually paying your invoice. Profit is what makes someone invest their money in a mechanical contracting business instead of investing in other mediums, i.e., the stock market, real estate, mutual funds, etc. The business should provide a rate of return that is competitive with other investment opportunities having a similar risk. A mark-up should allow for a reasonable rate of return on investment.

Risk

Every bid you produce has a certain amount of risk to its profitability. Each part of a mechanical contractor's DJC structure, by its very nature, has a different level of risk.

Construction Contractors: Your DJC's consist of four basic parts:

- **Subcontractors**
- **Equipment**
- **Sundry materials**, such as pipe, valves and fittings
- **Labor**

Subcontractors probably have the lowest risk. A subcontractor quotes the job, and must perform the work at the quoted price. The risk to you is that the subcontractor will not perform, either through disputes with the plans/specifications, recalcitrance, bankruptcy or other problems. But, if the subcontractor is a financially sound company run by people who care about an ongoing relationship with you, your risk may be lower with a subcontractor than with your other costs. Therefore, the mark-up on your subcontractors may be adjusted accordingly.

Equipment. The contractor will be responsible for the equipment purchased for the job—its installation, warrantee problems, delivery and scheduling issues, and any costs

associated with meeting the plans and specifications.

Suppose the owner/CM/GC buys the equipment? A contractor should consider that his job-risk for this category still exists in some form and a mark-up associated with that risk might still be appropriate.

Sundries. Since the contractor usually prepares a bill of materials from his own take-off of the job and then applies pricing, the risk of contractor error may be greater than an error would be for an equipment take-off. The quantity could be in error or the price-factors could either be wrong or could increase.

Labor. Labor presents the highest potential DJC risk to a contractor. Regardless of how sophisticated the tools are that we use to estimate labor on a job, there is no way to know precisely the number of man-hours needed for a job until the job is completed.

Service Contractors: Some DJC's are the same. However, usually the labor costs are a much higher percentage of the total DJC's. The OH structure for Service is, by its nature, much higher than on construction work.

Remember that every job is different and every contractor's OH cost structure is unique to that company.