

Overhead & Profit - The 10 & 10 Myth

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In the restoration industry today, the cost of doing business and the ever-changing market of how sales are generated is getting more and more challenging. One thing that hasn't changed is the 20% markup factor for overhead and profit, commonly known as the "10% & 10%" O&P. No one really knows who came up with the 10% & 10% concept, but most restoration contractors will agree that these allowances, especially the 10% allowance to cover overhead expenses are for the most part outdated and unrealistic. Overhead costs vary from company to company and the one size fits all mentality is not only unfair, but often detrimental to the survival of some restoration companies. In order for any for-profit company to survive, it has to make enough profit after costs to not only cover the operating expenses but have enough left over to grow the business as well as carry it through the slow times.

Most insurance carriers won't deviate from the 10% for overhead and 10% for profit markup without a fight, even if the contractor performing the work can prove that his or her company's overhead is more. One reason for this is that there are always contractors out there who are willing to work with these allowances. Prior to 2010, some carriers, including Allstate Insurance had varying amounts they would allow for O&P and some allowed as much as 19% for overhead and 19% for profit or more depending on the location, project complexity, or other factors. The adherence to the 10% overhead allowance in most of today's structural repair estimates has caused significant financial hardship for many restoration contractors. This is due primarily to the increased costs of doing business and the inability to make enough profit to cover the overhead burden.

One of the main reasons this problem persists is that there are too many contractors out there who are willing to drop their financial pants to get on approved vendor programs. Many become mesmerized with the idea that doing so will be the key to fame and fortune and a larger volume of work. This mindset is similar to the lure of gambling where you get a taste of winning a couple of hands, but in the end, the odds of beating the house are always stacked against you.

To better illustrate this point, I have compiled detailed lists of overhead expenses that a typical restoration contractor may spend to operate the business. I will use an example of a mid-size restoration company doing business for a period of one year with \$5,000,000 in annual sales. These sales figures are for structural reconstruction and restoration only and do not include mold remediation, structural drying, hazardous material abatement, content cleaning or content pack-out work since most insurance carriers today object to paying any overhead or profit on non-structural repair work. 10% of the annual sales in this example is \$500,000, which will be used to illustrate what most insurance carriers today allow to cover any contractor's overhead. Keep in mind that this list does not include every cost relative to overhead expenses but illustrates the bulk of what a mid-size company needs to operate. The 10% profit factor that insurance carriers also allow is not intended to help cover overhead costs, but is meant to allow the company to make a profit, grow the company, invest, etc. Let's take a look and see if 10% is a fair and reasonable allowance to cover the overhead.

Office & Clerical Expenses	
Office & Warehouse space lease (3000 sf. x \$1.75)	\$63,000
Legal fees	\$12,000
Accounting fees	\$3,000
Computer system & IT support	\$5,000
Computer software fees	\$3,000
Office telephone, fax, internet	\$1,200
Cell phones, cases, car chargers, screen protectors, etc. (25 units)	\$12,000
Tablets and iPads	\$3,000
Postage	\$3,000
Office supplies (ink cartridges, paper, file folders, etc.)	\$6,000
City business license fees	\$500
Contractors' license fee	\$450
Contractors' bond fee	\$125
Home Improvement Salesman license fees	\$150
Secretary of State Corporation Tax	\$800
Total	\$113,225

Marketing & Promotion Expenses	
Lunches (2 staff with clients 2 times a week)	\$8,320
Dinners (with clients twice a month 2 couples)	\$4,200
Coffee, pastries, donuts, candy for clients	\$7,800
Sporting events (once every two months)	\$1,800
Golf with clients (once a month)	\$5,000
Large corporate type event (twice a year)	\$5,000
Tradeshows / conferences (twice a year)	\$7,500
Advertising (brochures, business cards, print or web ads, signage, flyers, etc.)	\$35,000
Layout and design labor of marketing materials	\$5,000
Trade association membership dues	\$2,500
Total	\$82,120

Miscellaneous Expenses	
Paid sick days - 3 days (24 hours per employee per year x 24 = 576 hours)	\$17,280
Paid time off - 7 Holidays (56 hours per year x 24 employees)	\$40,320
Weekly safety meetings - OSHA (45 min. per week x 24 = 936 hrs. per year)	\$28,080
Drug testing (10 per year for new hires)	\$500
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Other Overhead Burdens	
Business start-up costs and old debt	\$
Tenant improvements	\$
Office furniture, computers, printers, etc.	\$
Health insurance	\$
Dental or eye health insurance	\$
Pollution insurance	\$
Life insurance or Key man insurance	\$
Traffic or parking citations	\$
General Manager's salary	\$
Human Resources Manager salary	\$
Business consulting fees	\$
Retirement or 401K plan contributions	\$
Cost to finance projects	\$
Line of credit interest fees	\$
Bank service charges	\$
Credit card processing fees	\$
Project errors or defects	\$
Lawsuit judgments	\$
Payroll or tax penalties	\$
OSHA fines or other fines	\$
Warranty work	\$
Leadership training	\$
Janitorial services	\$
Charitable donations	\$
Gifts or bonus's	\$
Liability insurance premium increases due to claims made	\$
Employment practices liability insurance premiums	\$
Down payments on company vehicles	\$
AAA roadside assistance	\$
Toll road fees	\$
Vehicle wraps or signage	\$
Notary fees	\$
Depreciation	\$
Inflation	\$
Unprofitable or underestimated work	\$
Embezzlement and theft	\$
Professional counseling (to cope with why the company is always broke)	\$
And the list goes on.....	\$
Grand Total	\$2,111,654+

Obviously, I haven't included every cost attributed to overhead and there may be a small margin for error, but these lists clearly illustrate that the operating costs far exceeds 10% of the \$5,000,000 in sales. This doesn't even account for the jobs sold that are not profitable. The totals for the items shown in this example accounts for over 43% in overhead costs for this company.

It's obvious that the business is operating in the red and paying far more than the typical 20% overhead and profit factors combined. If work gets slow or if there are difficulties collecting the accounts receivable, the income shrinks and any cash reserves are quickly depleted. This will cause the company to dip into their line of credit to make payroll and keep the lights on, which further increases the overhead. Any prolonged shortage of work or lack of income capital will result in laying off employees, making major cutbacks, or collapse. Even if this company reduced the salaries of some employees, eliminated commissions, collected 100% of the accounts receivable, got 100% efficiency from the workers in the field and cut other costs, the overhead will still remain far above 20%.

Wait, don't stop reading yet, there's more! Here are two more major financial burdens that can further increase the overhead of our example restoration company:

Franchise Fees

If the contractor happens to be a franchise, the franchise fees can range anywhere from 5-19% or more. Here we will use 5% of \$5,000,000.

Total

\$250,000

Contractor Referral Program Fees

These days more and more insurance carriers are using third party referral agencies or managed repair programs like Contractor Connection, Alacrity, Code Blue and others to refer restoration and flood mitigation contractors. These services charge anywhere from 3%-25% or more for the referrals they provide. Some insurance carriers have their own preferred contractor referral programs that require a percentage of the total repair amount discounted or kicked back on any work their vendors are given. These fees may range from 10% to 15% or more. Since most restoration companies get their work from different sources and not all their work comes through networks or referral programs, we will use \$1,000,000 of the annual sales as referral program work with a 10% fee.

Total

\$100,000

Now the total overhead comes to over \$2,461,654.00, which means the overhead percentage is over 50% of

the gross sales!

Given the costs shown in the example, it is clear that a restoration company of this size, with this amount of overhead can't make nearly enough profit using 10% for overhead and 10% for profit to stay alive. The only way a company like this will make it is by a combination of somehow cutting overhead costs, using cheap labor or subcontractors, inflating estimates to cover costs, cutting corners to reduce job costs, and doing more profitable work such as structural drying, mold remediation, or content cleaning and pack outs.

The inability of contractors to cover overhead expenses is one of the key factors why so many restoration companies fail and will continue to do so unless the overhead burden of the company is accurately reflected in their estimate's markup.

Free Estimates & Consulting

In addition to the general operating overhead expenses, restoration contractors are expected to provide free repair estimates and consulting time to insurance adjusters, agents, and property owners, especially if the contractor is on approved vendor programs. The expense for estimators to provide free estimates or consultation on a weekly basis is very costly. Based on two estimators averaging 10 hours per week each at \$86.00 per hour based on a salary of \$180,000 per year comes to \$89,440. Estimators are usually required to pre-qualify jobs before signing contracts, to be sure they will be profitable for the company. Estimators can see 4-5 jobs per day, and most do not become sales. Here are some circumstances that can affect the sales volume of restoration contracts:

- No insurance or insufficient insurance coverage

- Xactimate® pricing is too low to make the job worthwhile
- An administrator of a managed repair program drastically reduces the contractor's estimate to the point where the job will not be profitable
- Xactimate® pricing is too high to be competitive
- A competitor already signed the job and the client only wants a comparison estimate
- The job is too small
- The job is too big
- The job is too complicated or problematic
- The insured wants to cash out or do some of the work themselves
- The job is too far away
- The insured is looking for the lowest bid
- A public adjuster or attorney is involved
- The deductible is too high
- The insured wants to include extra non-insurance work at no additional cost
- The mortgage company withholds or subtracts repair funds to cover delinquent payments
- The insured wants their deductible absorbed

Workforce Inefficiency and Unbillable Time

One of the biggest financial burdens restoration companies face is labor inefficiency and unbillable labor time. Inefficiency and waste affect all types of businesses, but is especially costly to insurance restoration contractors. Insurance repair work and being on approved vendor programs requires contractors to have employees ready to respond to emergencies at a moment's notice. However, the time spent traveling to and from jobs, getting or returning materials, or doing other tasks off-site during a typical workday costs the company hundreds of thousands of dollars a year in unbillable labor costs. Here is an example of what this can look like:

John and Randy are given the task to do some drywall repairs on a home that has water damage. John is a journeyman carpenter and drywall finisher who gets paid \$25.00 per hour (with worker's compensation insurance, he costs the company \$33.00 per hour) and Randy is his helper who gets paid \$16.00 per hour (with workers compensation, he costs the company \$22.00 per hour). The job is budgeted to take two men 8 hours to make the repairs (16 hours).

They show up to the office at 7:00 am and meet with the project manager to go over the scope of work for the day. They get on the road by 7:30 and travel 45 minutes to the jobsite, unload their tools and get set up to start work. It's now 8:30 and John realizes he needs more drywall, masking tape, and screws, before he can start, so they travel 20 minutes to the nearest home improvement store. It takes 20 minutes to get the material, wait in line, and pay the cashier. Now they have to travel 20 minutes back to the job. They then decide to take a 15-minute break and start work at 9:45. At 11:30 John and Randy take lunch for 45 minutes and return to work at

12:15. They work until 2:00 and take another 15 minute break. At 3:00, they see it's getting late and gather their tools, clean up, and leave the jobsite by 3:15. They travel 45 minutes back to the shop and discuss with the project manager what is needed for the next day. John and Randy end up leaving the shop at 4:30 and clock out with an hour of overtime. John and Randy only actually worked on the project 4.5 hours, but the company had to pay each of them for 8 hours plus two hours of overtime. John and Randy will end up having to spend 2 working days to complete the job, which is 32 paid hours because they only could achieve an average of 4.5 hours per day of actual repair work.

Using the example of the mid-size restoration company, if half of the workers cost \$22.00 per hour and the other half costs \$33.00 per hour and everyone only produces 4.5 hours of actual hands-on work onsite, the company loses 3.5 hours per man per day (not including overtime).

Here is the math for a field workforce of 15 workers:

8 men @ \$33.00 per hour lose 3.5 hours per day x 5 days (140 hours x \$33.00) = \$4,620 per week

7 men @ \$22.00 per hour lose 3.5 hours per day x 5 days (122.5 hours x \$22.00) = \$2,695 per week

This means each week the company has to pay out over \$7,315 in non-productive wages (not including overtime) plus other expenses. This amounts to \$380,000 per year! The company would be better off firing everyone and using sub-contractors.

Granted, this seems more like an employee management problem, but even if John and Randy were more efficient and worked 6 hours on the job, there will always be lost labor time each day no matter how well employees are managed. This is due to time on the road, getting materials, breaks, time spent on the phone, etc. which cannot be billed to a specific job or recuperated.

It has been my experience that smaller to mid-size restoration companies are only a few months away from serious financial trouble or bankruptcy, especially when problems arise on jobs that stops progress, sales slowdown, receivables aren't collected, or cash reserves are depleted. When this happens and a company falls behind, they begin the process of robbing Peter to pay Paul. This means the company uses the funds from new contracts to pay off old debt, fund other projects, or make payroll.

Price Markup Example Broken Down

Let's look at a simple breakdown for a general contracting company that carries an overhead burden of 30 percent. This will show what the company needs to charge (or markup) to cover this overhead and still make 10 percent for profit. We will use a project that is estimated to cost \$100,000 in labor and materials. If you assume \$40,000 for gross profit and add it to a job cost of \$100,000 you arrive at a figure of \$140,000. Since overhead is based on total gross sales, now take 30 percent of the sale price to determine overhead and you get \$42,000 (.30 x \$140,000). Subtract that overhead from the job cost and you have \$98,000 remaining.

In this example, the contractor cannot cover all of his overhead costs, let alone realize any net profit. In this scenario, a job that costs \$100,000 will have to be marked up nearly \$67,000 to cover a contractor's gross profit (30% overhead plus 10% net profit) which is equal to 40 percent of the gross sale.

Example Job Cost Markup Table

Hard Cost	Overhead	Profit	Total Markup %	Markup Equation	Amount To Charge Customer
\$100	10	10	20	$\$100 \div 80\% = 1.2500$ \$125.00	\$125.00
\$100	15	10	25	$\$100 \div 75\% = 1.3333$ \$133.33	\$133.33
\$100	20	10	30	$\$100 \div 70\% = 1.4285$ \$142.85	\$142.85
\$100	25	10	35	$\$100 \div 65\% = 1.5384$ \$158.34	\$158.34
\$100	30	10	40	$\$100 \div 60\% = 1.6666$ \$166.67	\$166.67
\$100	35	10	45	$\$100 \div 55\% = 1.8181$ \$181.82	\$181.82
\$100	40	10	50	$\$100 \div 50\% = 2.0000$ \$200.00	\$200.00
\$100	45	10	55	$\$100 \div 45\% = 2.2222$ \$222.22	\$222.22

This table shows how a job cost must be marked up by a contractor to attain different percentages of gross profit. Gross profit contains both net profit and a percentage to cover the contractors' overhead. No two contractors will have identical overhead, nor does overhead remain constant. The definition of job cost or, in this case hard cost, is the actual cost of labor and materials to perform a given task before any markup is added to cover overhead and profit. In this example, we will use \$100 as the actual cost of materials and labor to perform a construction related task. The overhead column shows a percentage of markup over actual costs that may be charged by different contractors based on their varying overhead burdens. This is normally stated as a percentage of total sales. The profit column shows a contractor's profit margin remaining constant at 10% of total sales. The markup equation column shows the math used to achieve a numerical factor to calculate the correct markup.

Here is how the markup equation works: The first number in the equation is the job hard cost (actual contractor cost without any markup or profit added). The second number in the equation represents the percentage left over after the overhead and profit are removed. This is the amount needed to complete the work. The third number represents the decimal figure calculated after the hard cost is divided by the percentage needed to complete the work. The amount charged column is the job hard cost multiplied by this figure. It reflects what the contractor will need to charge a customer to cover the overhead and achieve the desired 10% net profit.

By this example you can clearly see that if a contractor is not careful to estimate the costs to cover the overhead and profit correctly, they won't be in business for very long.

My hope is that the information in this article will shed some light on what it can cost for a restoration contractor to stay in business and provide the level of service consumers expect after a disaster.

This article was taken from Sean's book Secrets of The Insurance Game. If you would like more information on this topic or would like to speak with Sean, you can reach him at Sean@TheRedGuideToRecovery.com.