

## **Even if you're hungry, you have to be able to pay for dinner.**

By; Glen Van Orman

In today's challenging world of designing and home building, I often hear someone say; "I just don't understand it. As bad as the market is and as slow as the builders are, you'd think there would be builders so 'hungry' for work they would drastically reduce the price they would charge to build my project. I just can't find anyone willing to drop their price enough."

My response to that is usually; "Remember; No matter how hungry someone may be they still have to be able to pay for dinner." What do I mean by that? The builder may indeed be 'hungry' for work; however, they cannot work for free and feed their family or continue to stay in business. It doesn't matter how hungry a builder is, there are fixed costs that cannot be reduced below a certain point unless you are willing to pay someone to let you work for them. Obviously, this is not the way to run a successful business.



Sticks and Bricks: The 'hard' costs of producing anything are the costs of the components that are required to produce that product. In home building, these hard costs would be; site work, concrete work, lumber, wiring, plumbing heating, windows, siding, labor, etc. Although these component prices do fluctuate to a small degree, (some more than others) based on market conditions, oil prices, (many building products are manufactured from petroleum based compounds) and labor costs, they cannot be eliminated to reduce the cost of a project. They must be there in some degree to construct any building project. Certainly, the choices made in specifying higher end products will have some impact on the project. Size of the project and correspondingly the amount of the materials also has a major impact on the budget. However, that's not really the point of the argument being put forth in this scenario.

The real issue is the misconception that if housing prices are falling, (in truth they are just experiencing a correction based on supply and demand) that new homes or remodeling/addition costs will fall as well. The misconception about the housing market's fall is I believe, due in large part to the mass media continually banging the big, deep, dread drum. Admittedly there are economic realities that are affecting the market; however, those realities are fed in a frenzy of doom that is played out every day in the news. Why? Bad news sells. Bad news is interesting. Good news? Not so much.

The misconception revealed: If an existing home on the market was worth \$245,000.00 two years ago, and that same home today is more likely to sell for \$195,000.00, and I am building a new home, I should see a similar reduction. A certain amount of the general public seems convinced that this is true.

The reality underneath: At the risk of over simplifying the process; once a project has passed the design stage, and moves to the builder's hands for bidding, those hard costs we discussed, will be tabulated to create an estimated cost for construction. After the hard costs are in, the builder will add his labor costs to the estimate, (which really are hard costs of another sort; wages for carpenters and the like are somewhat fixed, they have to eat as well) then he will add what he feels should be an acceptable margin (or gross profit) to the bottom line and arrive at the total cost for the project.

Ah hah! That's the one we were waiting for. His PROFIT MARGIN. Well, let's talk about that one. The average small builder's profit margin is used cover the fixed overhead costs; office expenses, (even if working from a home office there is still overhead to maintain that space) a truck, (a builder's most valuable tool) insurances, phones, possibly office staff, and other such fixed costs. Then there are the variable costs such as management and labor costs, which may include the builder's own time as well as any other carpenters and laborers that are employed on staff, add in fuel, tool maintenance and other variable expenses. And finally there is what he hopes will be left over after the dust settles. His Profit! In good times a builder may hope to clear 10%. In a tough market, that may drop to 5 or 6%. (or even lower!)

How do the margins work? A builder cannot afford to estimate the costs of what it will take to complete a project to a finite number and then contract to do the job at exactly that price with no margin. Not, that is, unless it is a cost plus job where no matter what is spent, there is a percentage paid on top of that for his contribution to the project. Why? One reason is unexpected costs. They are a real part of any building project, and although they can be minimized they cannot be eliminated completely.

Simply put; there must be something for contingencies. If the site requires more prep work than was estimated, the costs will increase. If the weather is worse than expected, there will be delays and days lost, and costs will increase. If a sub-contractor fails to complete his phase satisfactorily there may be costs to for the builder to step in and remedy the situation. If material costs increase between the time the job was estimated, and the time they are delivered, there may be increases. Some of the responsibility for these increases may be alleviated in the form of allowances (which are still going to increase the project's cost, it just becomes the customer's problem) or in some cases it may be possible to 'lock in' prices from the suppliers, but there are always surprises, and the builder is where the buck stops. Literally. If there is no provision for these unexpected additions, it will come out of the builder's pocket. This will make it hard for him to continue to eat.

Additionally, take a look at the percentages: In the example above, the price reduction on the existing home would have been about 20%. Going back to the builder's average expectation of 10%, it is clear that to match this kind of a perceived price structure, it would be necessary to somehow reduce the costs at least an additional 10% just to equal these numbers. Even if the builder were to 'cut corners', (use less expensive materials and employ other cost savings measures) there are just not those kind of savings available in the average project, while still maintaining the project's character. It comes down to what the builder is willing to do the project for, with regard to the margin.

It is simply not possible to take 20% or more out of a builder's estimate of construction costs just to get the job because he is 'hungry'. Ultimately, he will wind up starving.



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