How Much Should A New Contractor Charge?

by Frank Blau
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The following feature story ran in the June 1989 issue of Plumbing & Mechanical. While the prices have changed since the late 1980s, this article remains as useful now as it was then.

This letter is to ask you and the staff of Plumbing & Mechanical to invest some time and effort to solve a problem for me. If you can make a “project” of answering my questions, I’m sure it will be of interest to many other readers.

I want to start my own small plumbing company, specializing in repair, remodel, drain cleaning and small construction. Technical knowledge and practical experience are not a problem. I have been a union plumber for 20 years, working on nuclear plants, hospitals and other large construction projects. The last 12 years, I’ve worked for Natkin & Co. in the plumbing service department. As foreman, bidding jobs, dealing with commercial accounts and performing the work, I know the technical side. The business management and planning are areas where I need help.

The Small Business Administration has offered help, but they don’t know our specific industry. Their outline for a business plan suggests setting service call hourly rates at three times the hourly rate of your employee. Fifteen dollars per hour is a fair wage in Tulsa, Oklahoma, but by the formula, I would charge $45 per hour. The average service call is $35 per hour in our area. To start a new business and attract customers, it seems I would have to charge about $30 per hour. While working in Natkin, I have bid jobs competing with fly-by-night companies which charge $22 to $25. Your magazine has discouraged price cutting for years, and I agree, but how else can I succeed? Can you recommend a formula for arriving at a service call rate?

The SBA wants me to estimate my first year total sales volume. Is there an industry average ratio of materials to labor charges for a small service company? In other words, would it be safe to estimate my total yearly billing would consist of 2/3 labor and 1/3 parts and fittings? ...

If Plumbing & Mechanical is looking for an interesting project, assign a writer to ... advise the new company on name, financing, insurance, advertising, computerization and other subjects vital to an embryonic company. Your prompt response would be greatly appreciated ... Signed, Ronald L. Coates, Coweta, OK.

Yep, I got the assignment. I started by giving Mr. Coates a call to get more background information and just to chat a little. I found him to be pretty typical of the kind of person who aspires to PHC contracting.

He is 40 years old, married and has three wonderful children ranging in age from 11 to 18. He plans to start his enterprise from his home in Coweta, a suburb of Tulsa, which has a population of about 750,000. Coates said he has about $30,000 in seed money to start his enterprise, money derived from financing his home. He owns a 1978 Chevy van that he figures to make due for the initial year of operation.

Coates stated that his wife has office skills necessary—including job costing, billing, bookkeeping, phone reception, etc., and has past experience working for Natkin. He informed me that she would perform those tasks at no compensation. Ron stated that she probably would work a minimum of 20 part-time hours per week, or 1,000 hours per year, in the new enterprise, with additional income from another full- or part-time job to “make things go.”

First let’s dispense with some of the easier questions Ron poses. When it comes to choosing a name for the new enterprise, I’d just make sure to let the public know what kind of activity the business engages in. For instance, instead of calling it Ron Coates, Inc., it would make more sense to call it Ron Coates Plumbing-Heating, Inc. In regard to insurance, I’d just advise Ron to shop it like any other commodity. Also, make sure that the companies you shop have clientele who are construction-oriented companies.

The trickier questions concern money and as my first piece of financial advice, I told him that I was opposed to wives or anyone else being sold as slaves to the public. When told that Mrs. Coates earned $14,500 per year working for Natkin, I suggested that be used as a guide to what he should pay her.

Cost of Labor

From a friend of mine who's a union contractor in Tulsa, I found out that the current journeyman base wage rate is $15.86 and also got a detailed breakdown of fringes called for in the current agreement. In addition, we estimated an approximate payroll and insurance tax burden that may vary with each individual company. The hourly cost picture looks as follows (the percentages are percentages of the base wage rate):

Counting fringes as compensation, one sees that a Tulsa area journeyman who works 2,000 hours a year earns $47,860—not too shabby for a person who does not have the headaches and risk that a typical PHC contractor has. Ron informed me that he earns above the average compensation. With a maximum amount of overtime, the total compensation for a journeyman could reach as high as $80,000.

Know Your Costs

A key part of a questionnaire I pass out at my seminars asks, "What is the basic reason you went into business?" As you might guess, the most common answer is, "Earn more than you could working for someone else." This is Ron's basic reason, as well. He stated that he would be quite satisfied earning $60,000 the first year in business, which is about 1 1/4 times more than he presently earns.

Keep in mind that he and his wife will be the only employees generating the sales necessary to "harvest" $60,000 in owner compensation. What we need to do now is figure out the hourly selling price of labor needed to achieve that goal.

Remember, Ron needs to charge a bare minimum of $23.93 just to match what he gets from Natkin, but there is much more than that to consider. First of all, I'd like to see Ron and his family take a vacation two weeks out of the business year. This means that we'll establish a 2,000-hour work year for this embryonic company, based on the industry standard of fifty 40-hour weeks. (If he can get more work than that, great, but a brand new contractor is wise to be conservative estimating the amount of work that will come his way the first year in business.)

But remember, not only will Ron be the sole journeyman working in the field, he also will have to estimate jobs, sell jobs, purchase materials, pull permits and perform a multitude of other “non-productive” tasks. While he is doing those things he does not generate revenue, but instead becomes overhead.

I estimate that he will be non-productive for at least 500 of those 2,000 hours. This means that he only will have 1,500 productive hours available to be sold to the consumer. If we multiply that by the bare minimum compensation of $23.93, we end up with total annual payment of $35,895. That’s a far cry from his goal of $60,000 annual income, $24,105 short to be exact.

So how does Ron corral these dollars? One thing’s for sure, he doesn’t do it by charging less for his labor!

The $24,105 represents overhead, and dividing it by 1,500 hours gives us $16.07 per hour of additional overhead to cover Ron’s salary requirements. We must add this to the base labor rate of $23.93 to arrive at a $40 per hour cost. Multiply 1,500 hours times $40 and we arrive at the goal of $60,000 owner compensation.

But wait. Does this company have additional overhead? You bet your sweet life it does. If Ron takes my recommendation to pay his wife at least the same amount as she earned at Natkin ($14,500) we need to add an additional $9.67 per hour to cover her salary.

Then there is “general overhead,” covering things like truck repairs, gas, rent, phone, advertising, office supplies, callbacks, utilities, bad debts, legal and accounting, etc. A very conservative estimate to cover it all would be $15 per hour, times 1,500 productive hours, or $22,500 a year. So add $9.67 plus $15.00 to the $40 hourly labor charge already figured, and we reach a labor price of $64.67 per hour.

Still Rising

This is a far cry not only from the jackleg prices in Tulsa, but also from the prevailing rate of $35 and even from the $45 SBA recommendation that Ron thinks is way too high. But this is what he needs to do if he is to reach the personal compensation goal he set for himself.

Unfortunately, reality is even harsher than it appears so far. The $64.67 of hourly labor charge represents merely the break-even or “static-point” of business. If our assumptions are correct, it will cover all costs and provide the desired level of compensation for the Coates family, but will result in no profit for the business. Ron needs profit for future growth, to buy new vehicles and equipment (his ‘78 Chevy van isn’t going to last too much longer), to hire additional personnel and so forth.

What level of profit should Ron shoot for? Well, I say 23 percent net before taxes. That is about equal to what the McDonald’s corporation earns, and I figure a good plumber is worth at least as much as the people who fill our kids with salt and cholesterol. It’s far less than the average partner in a law firm earns, but we’re not as greedy as lawyers. (Though I often wonder, why shouldn’t we be?) To get a selling price with 23 percent net profit factored in, divide $64.67 by 0.77 (77 percent), to produce a selling price for labor of $83.99, of which $19.32 is net profit.

WHAT!! Please, lower your voices. I can hear your incredulous screams of disbelief all the way here in Milwaukee.

My friends, $83.99 per hour is not a fantasy or a fairy tale. It is an attainable labor rate. I am living proof of that. Although my company uses flat-rate pricing, it translates to substantially more than $83.99 hourly, and my net profit percentage is in the McDonald’s range, as well. (Much of the profit dollars go to my employees via a profit sharing plan and bonuses.) Of course, you better be good and provide superior products and services if you expect customers to pay premium prices, but that holds true for any walk of life.

Still skeptical? Then plug in any profit percentage you wish. If Ron wishes to lower his sights to 10 percent net before taxes, he can divide the static point rate of $64.67 by 0.90 to come up with a $71.86 hourly selling price of labor. If he’s content with merely 1 percent profit, he would have to charge $65.32. You can play still more games with the numbers by not paying your wife, or assuming more than

1,500 hours of productive work and so on. But at some point it all becomes an exercise in self-delusion.

The important thing is to know what your true costs of doing business are, and reward yourself for the investment, risks and long hours an owner puts into his business, along with the value you contribute to the marketplace.

The Material World

Let's turn to some of Ron's other questions. In his letter, he refers to labor and material ratios of 2/3 labor and 1/3 material. Actually, the opposite ratio, 1/3 labor and 2/3 material, is the ideal situation.

I'll settle for 25 percent material and 25 percent labor as cost of sales, thereby producing a gross profit margin of 50 percent for the service, replacement and remodeling market. (I'm hesitant to offer much advice regarding new construction—other than to stay far, far away from it! I was into new construction in the early days of business but couldn't make any money and got out. Many new construction contractors that I come into contact with through my seminars are looking to exit that market for greener pastures. This must be some people making good money in it, but I don't know how.)

Let's look at the figure 1, dealing with labor only. If Ron sold nothing but the commodity of labor (himself) for my recommended price of $83.99 per hour, he would earn $19.32 of net profit per hour for every one of the 1,500 hours he works in the field, and annual net profit before taxes would amount to $28,980 on sales of $125,985.

Figure 2 shows Ron's year-end statement with material costs equal to Ron's labor cost, the 23 percent net profit goal remaining constant. Note that first-year sales become $172,896 as compared to $125,985. Also note that the bottom line profit dollars have increased by $11,016 without having to add a single hour of extra work. Another significant factor to note is that overhead has decreased by 13.36 percent while overhead dollar expenditure remains constant. Such is the impact of material sales on a contractor’s business.

Just for the heck of it, let’s plug the same numbers and ratios into a P&L statement based on the SBA’s recommended labor rate of $45 an hour. Figure 3 reflects 1,500 hours or labor sold at $45. We again assume that material cost is equal to labor cost, and mark up the selling price of material with the same 23 percent profit margin used in the previous examples.

We see that total sales become $114,116, and the bottom line is reduced to a loss of $19,779. Ron has a problem. How does he get out of trouble?

Well, if he sells his wife for nothing, he’ll reduce his loss to $5,279. Still not good enough. Forget about taking the remainder out of general overhead — the $22,500 we assigned as a hypothetical amount is probably too low to begin with, and there’s no way Ron could cut it by almost a quarter. He could take a $5,279 cut in personal compensation, leaving him with a marginally respectable salary of $54,721 for the year. But that only leaves him at the break-even point. The purpose of a business is to earn a profit! And if he reduces his own income much further, he stands to make less than he does working for Natkin, which makes no sense at all considering the headaches and risks he assumes as an independent businessman.

So there is where he would be heading following the SBA’s guideline of $45 an hour. Imagine how steep the cliff is for those “blind men” rushing toward the edge with $22–$25 selling prices!

Dangerous To Health

Ron believes that the way to penetrate the market is to sell labor at less than the prevailing rate in Tulsa. Unfortunately, this thinking is all too pervasive among those who aspire to enter the PHC contracting business — pardon me — it’s pervasive among many who have been in the business for years, as well! This approach is very dangerous to your financial health.

Anyone entering this business had better lock into his mind the thought that the worst thing in the world is not to lose work because your price is too high. The worst thing is to lose money because your price is not high enough. You must assure that what you charge is adequate to cover all materials, labor, permit fees, overhead, plus a healthy profit.

I just don't see how it's possible for Ron to realize his financial goals charging $30 per hour as he suggests. He may indeed end up doing a lot of work, but for what? To earn less income than he now does as an employee of Natkin, and to bring home a whole bunch of headaches after hours on top of it? If that's the case, frankly, I think he would be better off staying employed by someone else. I urge him to continue to do some soul-searching about why he wants to go into business for himself.

He seems to feel that once he breaks into the market and builds a reputation, he can boost his rates. But that may take years, and what will he raise to, the prevailing market rate of $35? Far too often the prevailing market prices are wrong ones that do not rest on solid financial footing. There's too many blind men out there who don't know what their true costs are and we end up with the blind leading the blind.

I'm not sure Ron is happy with the way I've handled this assignment, but I fervently believe that the numbers I've crunched show the only sensible way for this good mechanic and good man to make it worthwhile to go into business for himself. My advice to anyone who has the desire to enter the PHC contracting business, or any other business for that matter, is very simple.

Before you establish any price, turn a wrench, install a water closet or boiler or whatever, immerse yourself in the kind of business mathematics covered in this article. Do it from the start and make it habit forming. Numbers crunching and eternal vigilance of financial data point the way to true business success.

In future articles, I'll delve further into the specifics of overhead items and other cost factors pertinent to the PHC business.

In September 1990, Frank Received This Follow-Up Letter:

Dear Frank:

After completing a year in the plumbing service and repair business, I have found most of your predictions were correct. I was able to charge for about 1,600 hours after the first year. Instead of charging the $83.99 per hour you computed, I charged the hourly rate of $35. This put me right in the middle of the rate charged by reputable firms in Tulsa. Close cost management and putting much non-compensated time made the year one of survival. The pay for all the investment and hours my wife and I put in amounted to about $30,000.

As you concluded in your article last year, it makes no sense to work this hard and invest so much for compensation that is less than one can make working for an hourly wage. I have therefore gone to work as a maintenance plumber for a major airline. My wife is running the business using a plumber she hired to replace me.

I am certain your response to this news will be, “You should’ve taken my advice and charged rates like I recommended.” It remains my contention that a new contractor cannot charge more than average. I had to work long and hard to come up with customers who used our services. I believe, had we charged more, fewer people would have switched to us.

Your message of demanding a respectable return on investment is right, how to implement it is the problem. No one company can afford to raise prices unilaterally. When the subject is brought up in industry association meetings, shrieks of “price-fixing” begin. Supply and demand are the true “price-fixers” in our industry. There will always be good plumbers who are poor businessmen, charging less than they can afford.

As the “guru” of the industry, your work in convincing and reforming the contractor is cut out for you. Those of us in the trade owe people like you and the others who write for Plumbing & Mechanical a big “Thank You” for your efforts. PM

Sincerely,

Ron Coates

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