

# Choosing your pricing strategy

*Knowing the benefits and disadvantages to your firm's pricing strategy is key to making it work*

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Photo: Fred Forbes Photogroupe

**W**hen prospects call your design/build company and tell you they are thinking about hiring a custom builder, this conversation is the unofficial start of the sales process. The prospect will have many specific questions while he evaluates you and your company. Simultaneously you are asking questions to determine if your company is able to meet their primary objectives.

Consumers today seek quality, service and value, and most recognize that one company can be the best in only two of these three areas while striving to be excellent in the third. I have elected to prioritize, and strive toward, giving my clients the best service while seeking to achieve the best value by using a pricing strategy. Some builders give clients the best value possible while allowing for profitability. How your design/build firm addresses this conundrum probably is revealed in the pricing strategy you implement.

Four basic types of pricing strategies exist for building a custom residential project. These include: fixed bid with allowances; fix bid with specifications defined; cost-plus with a fixed fee; and cost-plus a percentage. We will address these one at a time.

## Fixed bid with allowances

This is the most traditional method for bidding a custom project. The builder's proposal gives the client a fixed price for the total project and provides stated allowances for phases that typically are customized, such as kitchen cabinets and tile selections. If the allowances prove sufficient for the client to complete each allowance phase, the final project cost for the client will match the original bid

*The ability for the owner of this house to see major price increases gave him comfort because he was paying for exactly what he wanted.*



*Some builders give clients a fixed price for the total project, and allowances for custom work.*

amount. This pricing strategy allows the builder maximum pricing flexibility, i.e., increased profit potential, when asked to complete a change order or when the client's selections exceed the contractual allowances.

The builder also has the opportunity to bid the job with as high a profit margin as the market will bear. If actual labor and material costs for the job come in lower than originally budgeted, the savings drops to the builder's bottom line. Conversely, if actual costs are higher than budgeted, this will decrease the builder's profit margin. The builder does not reveal his bottom line to the client when using this pricing strategy.

## Fixed bid with specifications

The primary difference between this strategy and fixed bid with allowances is allowances are eliminated and replaced with predefined products and specs for all phases. In the builder's proposal, products are detailed and the client is left to choose only colors. If the client is satisfied with the builder's specifications, the total cost will match the accepted bid. However, any client deviation from the builder's specifications is handled by a change order and the builder's pricing is restricted only by his desire to be fair and reasonable. Again, the builder does not reveal his bottom line to the client when using this strategy.

## Cost-plus with a fixed fee

More precisely, this strategy is called "cost-plus with a fixed fee and all specifications and scope of work clearly defined." As the name suggests, it requires the builder to open his books and limit his profit margin while predefining all specifications and the overall scope of the project. From the builder's perspective, it's imperative the project be carefully and thoroughly predefined before the builder can commit to a fixed fee.

One particular successful high-end luxury builder colleague fell into exactly such a trap. He was building a 10,000-sq.-ft. home and agreed to a fixed fee for construction management. The client then made significant additions to the project, specifically a pool, pool house and extensive landscaping. The builder asked for additional fees but had difficulty maintaining a good relationship because the client had assumed the fee agreed to entitled him to grow the project indefinitely. Even a smaller change, like adding a cherry-paneled library when only wainscoting was in the specifications, requires additional management, supervision and responsibility on the builder's behalf. In 22 years of building custom and spec homes, never has one been completed exactly as originally planned. Therefore, it is difficult to create a win-win agreement for a fixed fee.

## Cost-plus a percentage

Open book construction management with the builder management fee calculated as a percentage of the total project cost is the best way to build a custom project both for my client and my design/build firm. There are, however, inherent challenges to this approach.

More time will be spent bidding and educating the client using this approach. A builder will be teaching the client about the nuances of residential building. More time is required to explain not only the bid process, but the clients will also be involved in reviewing and analyzing bids, as well as your company's negotiations with subcontractors and suppliers. Every bid is copied to the client and they need to sign off on almost all project expenses before they are incurred. Requests for funding require you to show the client every invoice and possibly an explanation as to why the original budget was exceeded by the actual cost.

You may feel as if you are training your client to become a custom builder, and in a sense, you are. The client will be a significant decision maker in the planning,

budgeting and execution of the project. For some builders, this may be intolerable; a fixed-price sale is easier for the builder during the production phase. Nonetheless, there are many advantages to open-book construction management that outweigh the additional time that goes into client communication and education.

Despite the challenges of extensive communication and education, I have enjoyed many quantifiable advantages to cost-plus building, starting with the sales process. It is an extremely rare prospect that will enter a contract for a fixed-price home with a custom builder without getting one or more competitors' bids. This type of environment is a given when your pricing strategy is fixed-price. When you master selling cost-plus, the prospect's need to seek multiple bids from several builders is eliminated since you are securing one or more bids on all major phases.

For example, the sketch (below) of a classic Georgian was as far as we went with a prospect that retained our design services and had purchased a prime building lot. We did preliminary estimating to identify the approximate cost of building this home. This included a great deal of educated guestimates since there were no construction documents at the time we asked the prospect to enter a construction agreement. However, since he understood we would be getting more than one bid per major phase, he was OK committing to build with us without firm plans and without securing a bid from any other builder. The owner is an educated consumer, not only because he had built a new home before, but because his day job is doing brain surgery. In addition, his wife is an experienced real estate investor who owns and manages many properties.

## Sharing equals winning

Cost-plus is win-win during the custom selection process. The front door pictured on pg. 1 is from a luxury home we built a couple of years ago. When this cost-plus client started selecting his front door and surround, he did not have a restricted budget so he took us to task in getting him the best value. After many design drafts were circulated between the client and the primary architect, we secured bids from five custom door manufacturers.

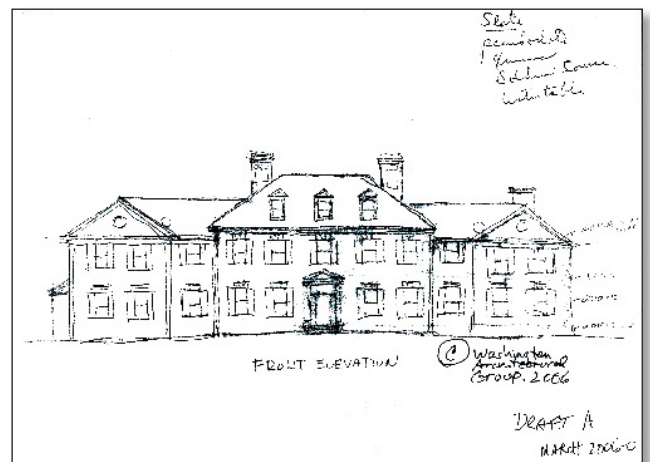
After reviewing all five door bids and meeting with four of the representatives, we selected the winning bidder and went through several shop drawings with their production draftsman. Each modification of the design, such as adding the beveled glass and specifying the depth of the cuts in the wood panels, impacted the supplier's price.



*Rarely, if ever, is a custom or spec home completed as originally planned, making it difficult to create a win-win agreement for a fixed fee.*

Since we were open-book, bids flowed directly from the door manufacturer to us and our client. His ability to see firsthand major price increases gave him comfort because he was paying for exactly what he wanted. Eventually he signed off on a \$20,000 door with \$15,000 in custom limestone. The salesman thanked me for sharing his bids directly with my client. He remarked that some builders may have added such high margins that completing the sale would have been much more difficult.

The pricing choices you make will impact your business and income so have a game plan and strategy for converting all the custom-home prospects who knock on your door into clients. ▀



*The client for this design understood the builder would get more than one bid per major phase, which made him comfortable to commit.*