

Understanding & Implementing Breakeven Pricing

Breakeven is a concept that you should become familiar with even if you do not plan to use it in your pricing strategy.

Breakeven simply means when we have sold enough dollars to cover our costs, and we have no losses, or no profits at that breakeven point. When we reach breakeven, we are at the point that we only have to deal with our variable costs of selling, and variable costs of overhead.

Let me explain further:

Any business has these costs: Cost of Sales (COGS) – those costs that are related to sales
Overhead Expenses – those costs that relate to operating

Break these costs down into more detailed categories and show what they look like in a profit and loss statement and this is what you may see:

Brief examples:

Not intended to be all encompassing

Sales	1,000,000	100%	
Cost of Sales (COGS):			
Direct Labor (Burdened)	190,000		
Materials	180,000		
Equipment	250,000		
Subcontract/permits	10,000		
Sales Commissions	50,000		
Total Cost of Sales	680,000	68%	
Gross Profit \$	320,000	32%	
Overhead (operating) Expenses			
Variable OH	150,000	15%	
Gasoline			
Advertising			
Freight			
Telephone Expense			
Travel & Entertainment			
Office Supplies			
Fixed OH	100,000	10%	
Rent			
Real Estate Taxes			
Utilities			
Total Overhead Costs	250,000	25%	
Net Operating Profit	\$ 70,000	7%	

These are both Variable costs

As you can see, the costs of sales are variable. This is primarily due to the labor related costs. Then you have the overhead expenses, which are variable, and fixed. We care about this type of breakdown because the variable costs are costs that come when we sell something, meaning they are overhead expenses but related to the sales curve. This is important as we learn about breakeven.

So to calculate breakeven, we simply take the overhead (operating expenses) and divide this figure by the gross margin percentage. In our example above our breakeven would look like the following:

Operating Expenses

(Gross Margin Percentage %)

= Breakeven Sales

\$250,000 Operating expenses

32% Gross Margin %

= \$ 781,250 Breakeven Sales

So the figure of \$ 781,250 is what we need to reach our company breakeven for the *YEAR*, if we maintain our operating expenses (overhead) at the level we planned for here (\$250,000) and our margin percentage (Sales -cost of goods sold = 32%).

We can represent the figures yearly, or monthly!

We can also use this to help us identify how we can manage pricing strategy based on what is happening with our sales curve.

Once we have reached breakeven for the month, or for the year, we can begin to price by leaving out fixed overhead costs (10% in our example) if we CHOOSE TOO! We may not want to, but it is nice to know we can!

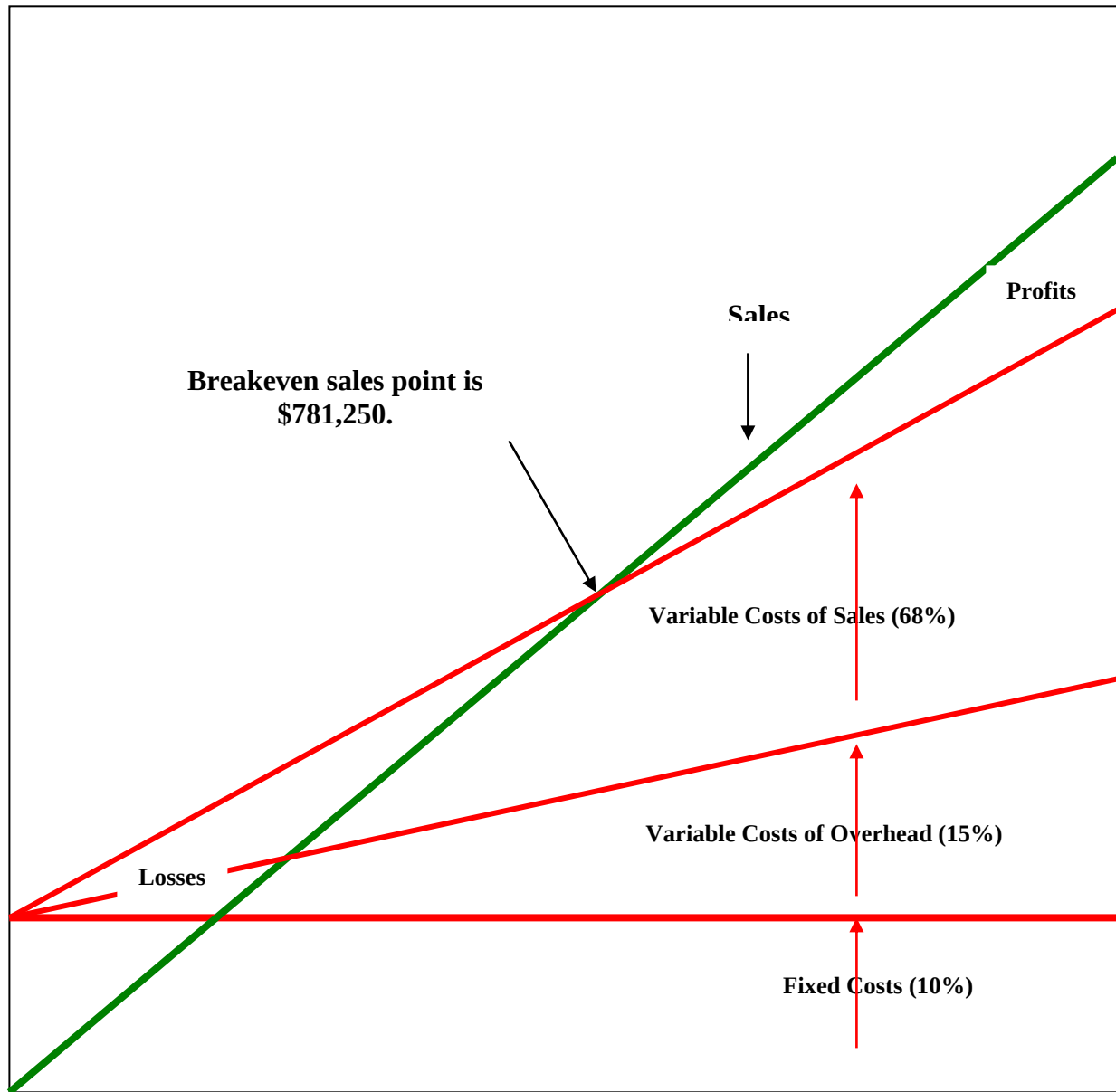
The concept of breakeven in our example is applied to the graphic on the next page.

It tells us where our company must sell to meet our costs associated with our company as it operates today, meaning a 32% gross profit margin, and an overhead cost of \$ 250,000 for the year. This is a relationship your company should know monthly, and also for the total year based on:

1. A budget at the beginning of the year
2. An updated set of figures as actual sales occur through the year

We can then decide once we have met our breakeven if we want to change pricing strategy. Look at the graph, and then we will review examples of how it can be applied.

Breakeven Analysis Representation – Applied to Price



After you reach breakeven for the month, or for the year, you have some level of pricing flexibility. This is why some contractors seem to change their prices late in the year.

Your fixed costs have been totally covered once you have reached breakeven for the year, and now you have the ability to price, using only the variable costs in your business.

It is an excellent strategy, but also one that you should think through carefully because adapting your prices has consequences. Neighbors talk. Price points get established for this type of job. Pricing communicates our “Value”, so be very aware and careful about using this approach.

The Use of Breakeven – Strategy

Breakeven has several benefits.

1. Knowing breakeven by month allows you to have some flexibility to manipulate your prices and still make money so long as you have passed breakeven, and have recovered the costs of sales and your variable overhead costs. In our example that was 68% + 15% for a total cost structure after breakeven of 83%. Or put another way, we could take 10% out of a job and still make our 7% net operating profit.
2. The strategy of doing so can be a good one. It also has consequences. Pricing variations are tricky when used in retrofit.
3. In construction this is the norm. Since in many cases you are forced to know how low you can go, or what we call the walk-away figure - breakeven can be powerful as an ally.

A case in point is when we combine dual overhead pricing methodology with breakeven analysis.

At a certain point in the fiscal year, we reach breakeven (call it January 15th). Our fiscal year is matched with our business seasonality so we start our year May 1st, and end our year April 30th to coincide with how revenue trends come into our business.

So January 15th, we hit breakeven, where we have covered our fixed costs for the year, meaning we have hit 781,250 in sales at a 32% margin, and our operating expenses are tracking at \$250,000.

Since we are departmentalized, and know our overhead is broken down into each market segment, for commercial and new home we know our labor and material factors are less than they are in retrofit (see the dual overhead material).

Our factors are 1.16 for materials and 1.99 for labor. So any labor costs get multiplied by 1.99 and any materials, equipment and subcontract costs get multiplied by 1.16. When you add both of these two sums together on any job bid, you get the job breakeven with no profit added yet. However, remember what I have said, that we have actually reached our yearly breakeven.

That means our dual overhead factors can be changed, if we CHOOSE to change them to become more competitive. We have the option now, since we are past breakeven for our fixed overhead costs for the year, to use an adjusted set of dual overhead factors to re-calculate the new job breakeven amount with the newer factors.

It can sound confusing, and it is a very sophisticated pricing concept, but look at the example on the next page. This is what knowing your numbers can do for a business1

Standard job price with Dual Overhead factors from our P&L for a standard company, not departmental, and before the breakeven has occurred for the company (prior to reaching 781,250 in sales).

Dual Overhead Ratio Method

Great for Commercial, or New Construction Bid Process

Direct Costs	Dollars	Percent @ 10%
Direct Labor Dollars (non-burdened)	\$ 350.0	12.63%
Equipment Costs	\$ 950.0	34.28%
Materials/Parts dollars	\$ 300.0	10.83%
All Forms of Unapplied Labor Expenses Added	\$ -	0.00%
Subcontracts	\$ 50.0	1.80%
Allocated Fringe Benefits	\$ 84.0	24.00%
Job Start-up Costs	\$ -	0.00%
Warranty Expenses (Reserve) - & Extended Warranty	\$ 25.0	0.90%
Permits	\$ 50.0	1.80%
Buydowns for Financing	\$ 30.0	1.08%
Equipment Rentals	\$ -	0.00%
Total Direct Cost of Sales	\$ 1,839.00	66.37%
Selling expenses (Direct Costs)		
Commissions	\$ -	0.00%
Total Years Labor Dollars - Full Year or Budget	\$ 180,000.00	
Total Years Material/Parts/SUBS Dollars - Full Year or Budget	\$ 440,000.00	
Overhead Dollars - either last full year or budget year	\$ 250,000.00	
Overhead Factor for Materials & Parts (MOM)	1.16	
Overhead Factor for Labor	1.99	
Breakeven Sales Price (NO PROFIT ADDED YET)!	\$ 2,519	

Sale Price @ 10% Profit (Markup factor multiplier of 1.1* Breakeven Costs)	\$ 2,771
Sale Price @ 15% Profit (Markup factor multiplier of 1.18 *Breakeven Costs)	\$ 2,897
Sale Price @ 20% Profit (Markup factor multiplier of 1.25* Breakeven Costs)	\$ 3,023
1.16 Materials Factor - or Materials Overhead Markup(MOM)	\$ 1,636.76
1.99 Labor Factor - or Labor Overhead Markup(LOM)	\$ 861.78

The job breakeven is \$ 2,519. And with a 10% profit added this job is priced at \$ 2,771. Compare that to the Next page when we have passed yearly breakeven, and have recalculated the figures using departmental construction figures for labor and our material related costs from the Profit & Loss Statement.

The job price using Dual Overhead factors from our P&L for a departmental company, after breakeven has occurred for the company (after reaching 781,250 in sales).

Dual Overhead Ratio Method

Great for Commercial, or New Construction Bid Process

Direct Costs	Dollars	10%
Direct Labor Dollars (non-burdened)	\$ 350.0	15.31%
Equipment Costs	\$ 950.0	41.54%
Materials/Parts dollars	\$ 300.0	13.12%
All Forms of Unapplied Labor Expenses Added	\$ -	0.00%
Subcontracts	\$ 50.0	2.19%
Allocated Fringe Benefits	\$ 84.0	24.00%
Job Start-up Costs	\$ -	0.00%
Warranty Expenses (Reserve) - & Extended Warranty	\$ 25.0	1.09%
Permits	\$ 50.0	2.19%
Buydowns for Financing	\$ 30.0	1.31%
Equipment Rentals	\$ -	0.00%
Total Direct Cost of Sales	\$ 1,839.00	80.42%
Selling expenses (Direct Costs)		
Commissions	\$ -	0.00%
Total Years Labor Dollars - Full Year or Budget	\$ 45,000.00	
Total Years Material/Parts/SUBS Dollars - Full Year or Budget	\$ 200,000.00	
Overhead Dollars - either last full year or budget year	\$ 25,000.00	
Overhead Factor for Materials & Parts (MOM)	1.02	
Overhead Factor for Labor	1.45	
Breakeven Sales Price (NO PROFIT ADDED YET)!	\$ 2,079	

Sale Price @ 10% Profit (Markup factor multiplier of 1.1* Breakeven Costs plus Comm	\$ 2,287
Sale Price @ 15% Profit (Markup factor multiplier of 1.18 *Breakeven Costs) plus Con	\$ 2,391
Sale Price @ 20% Profit (Markup factor multiplier of 1.25* Breakeven Costs) Plus com	\$ 2,495
1.02 Materials Factor - or Materials Overhead Markup(MOM)	\$ 1,437.26
1.45 Labor Factor - or Labor Overhead Markup(LOM)	\$ 630.83

Look at the new breakeven cost of the job at \$ 2079 with the exact same costs associated with the job. The difference, *we used new factors to multiply with (1.02 for materials, and 1.45 for labor)* because we are now departmental, and *we removed 10% fixed costs from our overhead rate (which for construction was \$ 28,000 and we could use \$ 25,000 = to a 10% reduction for fixed costs no longer necessary with passing breakeven)*. So when we plugged in our REAL financial condition, this is the price structure we **COULD USE if we needed to**. At a 20% profit we can sell this job at \$ 2,495, which is well below the 10% profit of \$ 2771 previously priced, and even **BELOW the previous breakeven job figure of \$ 2,519!** Even the sophisticated contractor using dual overhead, who didn't use breakeven analysis would be wondering how?

Why is this Critical to Your Success?

- ❑ It's not critical to your success, but you will run into contractors who can compete at this level. One of them is writing this too you! And there are many who can accomplish this task. It helps them because it forces them to **KNOW YOUR NUMBERS!**
- ❑ Breakeven analysis gives us our sales target for the week, month, or year. It gives us the point we are trying to pass each and every month based on expenses we know are part of our contracting world.
- ❑ As we set residential pricing (or any pricing), we need to understand how important it is that we set the prices correctly for our costs and to recover enough gross profit dollars, to make money with our overhead, which includes our fixed overhead costs, and our variable overhead costs.
- ❑ Overhead cost (sometimes referred to as operating expenses), typically budget out in contracting, at 2/3 of overhead being fixed, and 1/3 of overhead being variable expenses. You need to create a budget and track your actual expenses in overhead to be certain, this has been a 30 year pattern observed via many financial budgets, businesses in contracting, and experience. Labor drives overhead and this is the reason for this typical result.
- ❑ Continuous adjustment of our prices is necessary as the market changes, products change, and we change. Breakeven analysis helps us know when to adjust, and how to adjust.
- ❑ Proper pricing systems, and proper communication of value offer you a great chance at making double-digit profits and definitely will help you, price for profitability!