

Planning for Profitability - Then Achieving It!

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I. WHAT IS GOOD PROFITABILITY?

- A. Good profitability should be 8% to 12%
- B. Superior profit builders are making 15% to in excess of 20% Net Profits
- C. Average for the industry is between 3.5% and 5.0% (Exhibits 1 and 2)

II. HOW TO BECOME A PROFIT ORIENTED BUILDER

- A. Shift your focus to manage for **PROFITABILITY**, not sales volume
 - 1. Managing for profitability means you are seeking customers who place value on your homes and services
 - 2. Focus on creating value for your customers
 - < Define your market segment (s)
 - < Understand your customer's needs, preferences and buying patterns
 - < Understand your customers' perceived value
 - < Define customer value
 - < Create a strategy to deliver superior value
 - 3. Volume oriented builders:
 - < Try to service all market segment and tend to dilute their effort, resources and profitability
 - < Fight for every deal

- < End up with an increased number of bad deals
- < End up with lower profitability rate
- B. Establish a Profit Objective
 - 1. Obtainable
 - 2. Motivational
 - 3. Superior profit builders have worked many years
- C. Focus on items within your control
 - 1. Price homes for the market *NOT* cost
 - 2. Control construction costs
 - 3. Balance operating expenses with sales volume
 - 4. Maintain appropriate sales velocity
- D. Implement good management practices
- E. Develop quantifiable objectives
- F. Compel events to conform to the plan
- G. Continually improve ALL management processes
- H. Involve the entire organization as a TEAM

III. BALANCE THE FOUR COMPONENTS TO PROFITABILITY

- Sales Velocity
- Sales Price
- Construction Cost
- Operating Expenses

A. Sales Velocity

1. Chart sales velocity (Exhibit 3)
2. Set target sales velocities for your communities

Considerations:

< Fixed expenses

- Model and sales center
- Advertising, signage, brochures
- Sales staff and support
- Superintendent and field staff
- Construction trailer and temporary facilities

< Activity Levels

- Viable community
- Level of excitement
- Motivational

< Production Capacity

- Superintendent
- Subcontractors

< Method of releasing starts to the field

- Capacity
- Consistency
- Accuracy

< Profit and duration objectives for the community

B. Relationship between sales velocity and sales price

1. Higher price = Lower velocity
2. Lower price = Higher velocity

C. The Affordability Triangle (Exhibit 4)

1. Functions in all price ranges - Hierarchy of affordability triangles
2. Too many builders end up at the upper end

< Inefficient communities with lack of sales

- < Typically cost driven through:
 - Design
 - Specifications
 - Construction costs
 - Construction techniques and controls

D. Sales Price

1. Market Sets Sales Price

- < Appraisers
- < Realtors
- < Home buyers
- < Competitors

2. Builder Modifies Marginally

3. Typical Pricing Method

- < Cost Basis Pricing
 - Plans and Specifications
 - Competitively Bid
 - Mark-Up Costs to Determine Sales Price
- < Market and Cost Basis Sales Prices *Don't* Match
- < Costs *Do Not* create Value
- < Profits squeezed as the Residual

4. Recommended Pricing Method

- < *Do Not* treat Profits as a Residual
 - Establish a Target Profit Rate
- < Determine Market Sales Price
- < Deduct your Target Profit
- < Deduct Land Cost (if included)
- < Deduct Operating Expense Allocations

- < Deduct Historical Slippage Rate
- < Remainder available for Direct Construction Costs (Exhibit 5)
- < Develop Target Budgets for Direct Construction Costs (Exhibit 6)
 - Design, Specify, & Estimate toward Targets
 - Protect your Profits
 - Trade off Direct Cost **NOT** Profits
- < Account for Historical Cost Slippage
 - Historical Unbudgeted Construction Costs
 - Fill-in Material Orders
 - Subcontractor Extras
 - Rework and Corrections
 - Can account for a substantial loss of profit
- < Account for Subdivision and Site Specific Expenses
 - Modify budgets
 - Creates Value** adjust Sales Price
 - Many **do not** create Value
 - < Treat as Slippage
- < Anticipate Cost Increases
 - Too often increases are **reactionary**
 - Catch up mode with lost profits
 - Increase is substantial and unannounced
 - < Lost sales velocity
 - Analyze Cost Increases during last year.
 - Consult Subcontractors and Suppliers
 - Determine Anticipated Cost Increases
 - Develop Strategy for Increasing Sales Prices
 - Communicate sales price increases in writing.
 - Advanced Notification
 - Additional Closing Tool
 - < Creates Urgency

- E. Construction Costs
 - ! Greatest potential for Increasing Profitability
 - ! Largest Classification of costs
 - ! Variable Costs
 - ! Increases Marginal Rate of Profitability

- 1. Get Rid of Bad Deals
 - < Major source of lost profits
 - < Conduct gross profit analysis (Exhibit 7)

- 2. Analyze Standard Specifications
 - < Develop practice of Azero@ base specifications
 - Strip standard specification to basics
 - Conduct cost/benefit analysis
 - Add back items giving adequate returns
 - Create Options and Upgrades
 - < *Do Not* over do a standard feature

- 3. Eliminate Waste and Excess Material Usage
 - < Trash pile represents lost profits
 - Only tip of the iceberg
 - < Police diverted materials
 - < Watch excess materials installed
 - < Return extra material for credit
 - Document to Accounting and Estimating
 - < Conduct Variance Analysis
 - Determine cause
 - Correct cause
 - < Develop Scopes of Work for Subcontractors
 - Implement a check list
 - Assure work is complete and accurate
 - < Conduct Aas-built@ audits
 - Assure material used as intended
 - Instruct workers in proper use of materials

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4. Value Engineer Plans
 - < Analyze for construction efficiency
 - < Implement material and labor saving techniques
 5. Gain Control of Construction Slippage
 - < Document fill-in orders and extra work
 - < Develop a strategy for reducing variances
 6. Improve Estimating and Purchasing
 - < In-house detailed quantity survey estimating
 - < Implement formal purchasing procedures
 - Use Written P.O.=s
 - Use Variance P.O.=s
 7. Variance Eradication
 - < Document variances
 - < Determine the cause of the variance
 - < Prepare timely management reports (Exhibits 8 and 9)
 - < Hold variance review meetings
 - < Assign accountability
 - < Train the work force
 - < Develop policies and procedures
- F. Operating Expenses
1. Watch staffing levels
 - < Maintain balance with sales volume
 2. Maintain adequate sales velocity
 3. Maintain construction schedules

- < Continually work to reduce
- 4. Watch level of unsold inventory
 - < Balance levels with sales velocity
- 5. Balance number of models with available lots
- 6. *Do Not* over departmentalize
 - < Staffing tends to increase
 - < Hinders communications
 - < Causes bottlenecks

IV. SALES PRICE, CONSTRUCTION COST, AND OPERATING EXPENSE IMPACT ON PROFITS

A. The dynamics of sales price changes

1. Decisions to increase sales price increases the marginal rate of profit

An increase in sales price by \$1,000 for a 100 unit a year builder increases revenues by \$100,000

2. Increases in sales price tend to reduce the sales velocity

B. The dynamics of construction cost changes

1. Reduction in construction costs increases the marginal rate of profit

A reduction in construction costs by \$1,000 for a 100 unit builder increases profits by \$100,000

2. Reductions in construction costs typically do not impact sales velocity

3. Can reduce sales price dollar for dollar of construction cost reduction, thus increasing the percentage of profit and possibly increasing sales velocity

C. The dynamics of operating expense changes

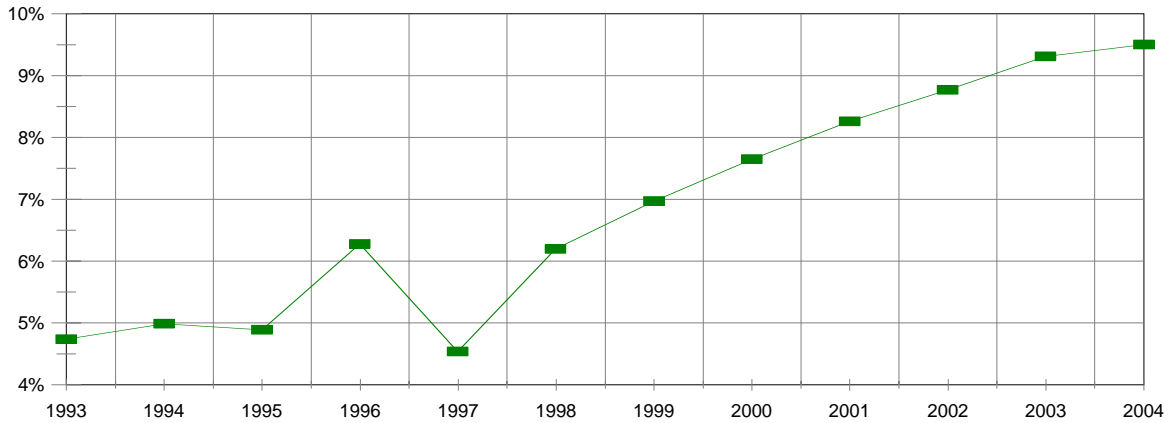
1. A reduction in operating expenses **DOES NOT** increase the marginal rate of profit

A reduction of operating expenses by \$1,000 will only increase profits by \$1,000. There is no multiplier

2. Many builders will increase operating expenses to reduce construction costs because of the dramatic impact reducing construction costs has on profits

EXHIBIT 1

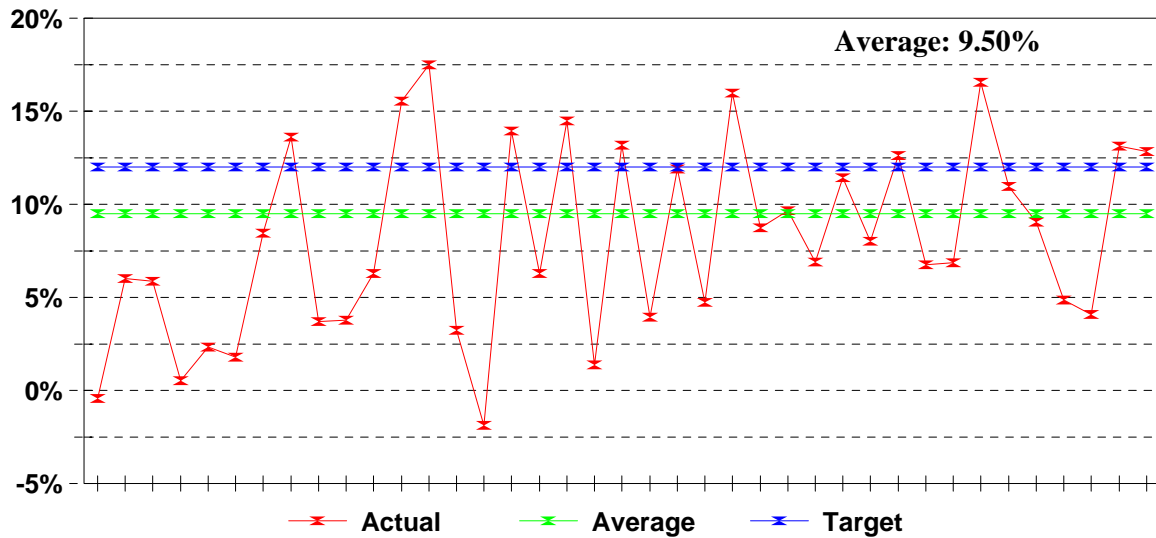
Net Profit Averages



Source: 2004 Financial Analysis – Preliminary Results: Study by Emma S. Shinn, Shinn Consulting. Littleton, CO.

EXHIBIT 2

**2004 Financial Analysis
Net Profits by Ascending Volume**



Source: 2004 Financial Analysis – Preliminary Results: Study by Emma S. Shinn, Shinn Consulting. Littleton, CO.

EXHIBIT 3
Actual Sales
2001 - 2004

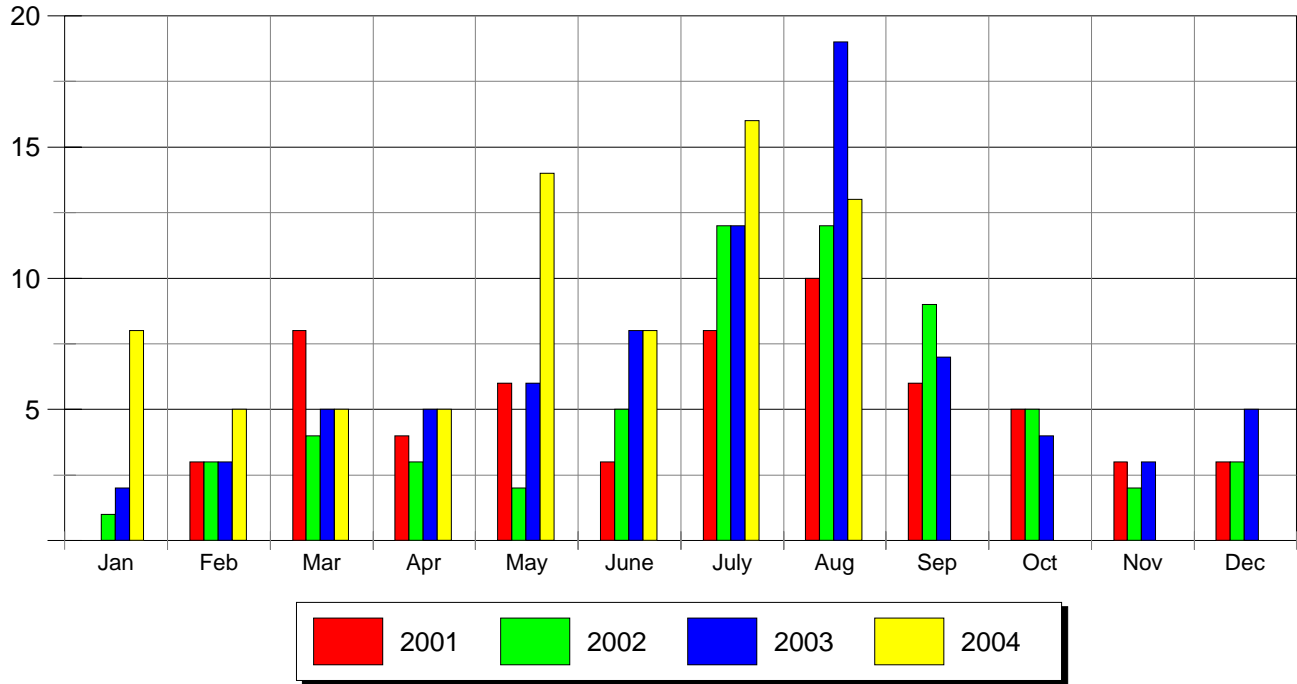


EXHIBIT 4

The Affordability Triangle

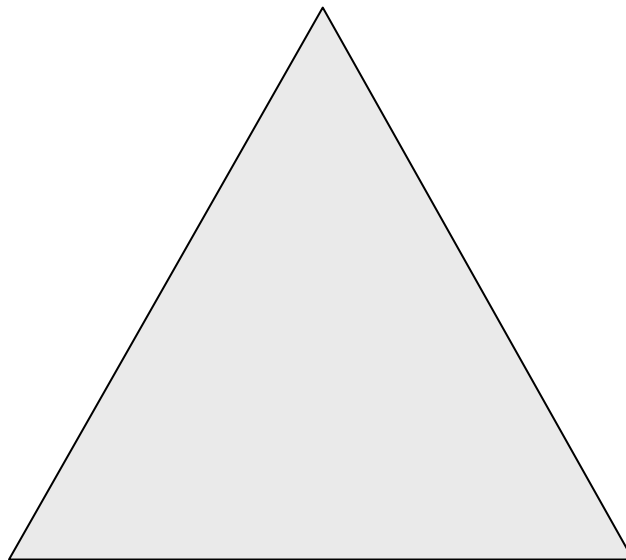


EXHIBIT 5**MARKET BASE AVAILABLE CONSTRUCTION COST BUDGET**

	Factor	Budget
Sales Price	1.0000	239,000
Profit	0.1000	23,900
Land	0.2000	47,800
Financing	0.0400	9,560
Marketing	0.0600	14,340
Indirect Construction Costs	0.0300	7,160
Warranty	0.0050	1,200
General & Administrative	0.0450	10,760
Historical Slippage	0.0200	4,780
Total Direct Construction Costs	0.5000	119,500

EXHIBIT 6
PRELIMINARY DIRECT CONSTRUCTION COST BUDGETS

TOTAL DIRECT COST BUDGET	0.5000	\$119,750
PRELIMINARY		
Plans	0.0023	\$540
Permits	0.0131	\$3,130
PREPARATION		
Excavation	0.0069	\$1,650
Foundation	0.0780	\$18,650
Steel	0.0024	\$580
Waterproofing	0.0013	\$310
ROUGH STRUCTURE		
Lumber- frame & trim	0.1013	\$24,210
Trusses	0.0081	\$1,940
Stairs	0.0027	\$650
Winds & Sliding Doors	0.0153	\$3,660
Front Door	0.0021	\$500
Garage Doors	0.0035	\$830
Framing Labor	0.0031	\$7,440
Fireplace	0.0050	\$1,190
Gutters & Downspouts	0.0024	\$570
Roofing	0.0100	\$2,390
Masonry	0.0091	\$2,170
Utility Connections	0.0020	\$470
FULL ENCLOSURE		
Plumbing	0.0426	\$10,200
Heating	0.0105	\$2,520
Electrical	0.0108	\$2,580
Telephone	0.0005	\$120
Insulation	0.0102	\$2,440
Drywall	0.0241	\$5,750
INTERIOR FINISH		
Interior Trim	0.0310	\$7,410
Painting	0.0138	\$3,290
Cabinets	0.0080	\$1,920
Counter Tops	0.0035	\$840
Wall Tile	0.0047	\$560
Shower Doors & Mirrors	0.0013	\$310
Hardware	0.0019	\$550
Appliances	0.0070	\$1,680
Electrical Fixtures	0.0031	\$740
Vinyl Flooring	0.0022	\$540
Carpet	0.0151	\$3,610
COMPLETION		
Finish Grade	0.0026	\$620
Final Clean	0.0022	\$530
Com. Labor & Clean	0.0056	\$1,350
Miscellaneous	0.0025	\$600

EXHIBIT 7

GROSS PROFIT ANALYSIS

Community: _____	Contract date: _____
Job Number: _____	Start date: _____
	Closing date: _____
Lot Premium)_____	\$ _____
House Price	\$ _____
Options and Upgrades	\$ _____
TOTAL CONTRACT PRICE	\$ _____
Less SALES CONCESSIONS	\$ _____
NET CONTRACT PRICE	\$ _____
COST OF SALES:	
Lot	\$ _____
Total direct construction costs to date	\$ _____
Open budgeted items (not yet invoiced)	\$ _____
TOTAL COST	\$ _____
GROSS PROFIT (Net contract price – Total cost)	\$ _____
GROSS PROFIT RATIO (Gross Profit / Total Contract Price)	_____%
VARIABLE EXPENSES:	
Commissions	\$ _____
Financing	\$ _____
Closing Cost	\$ _____
TOTAL VARIABLE EXPENSES	\$ _____
CONTRIBUTION MARGIN (Gross Profit – Total variable expenses)	\$ _____
CONTRIBUTION MARGIN RATIO (Contribution Margin / Total Contract Price)	_____%

EXHIBIT 8

Majestic Homes
\$ Variance - 4/30 YTD

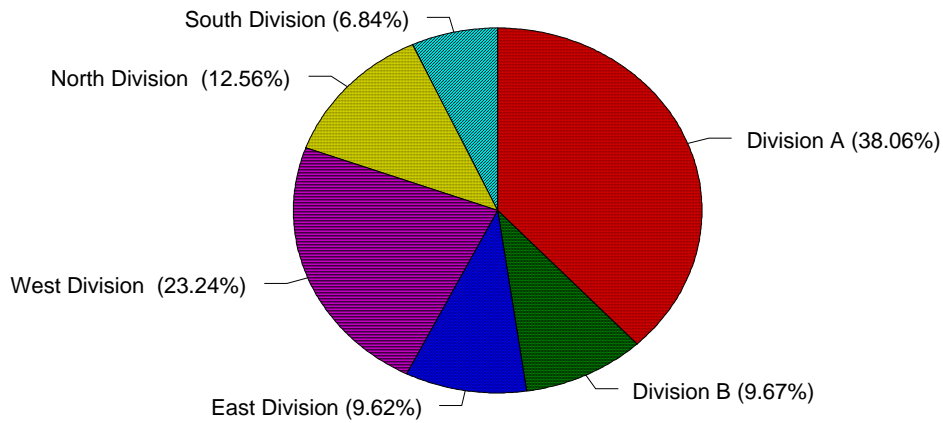
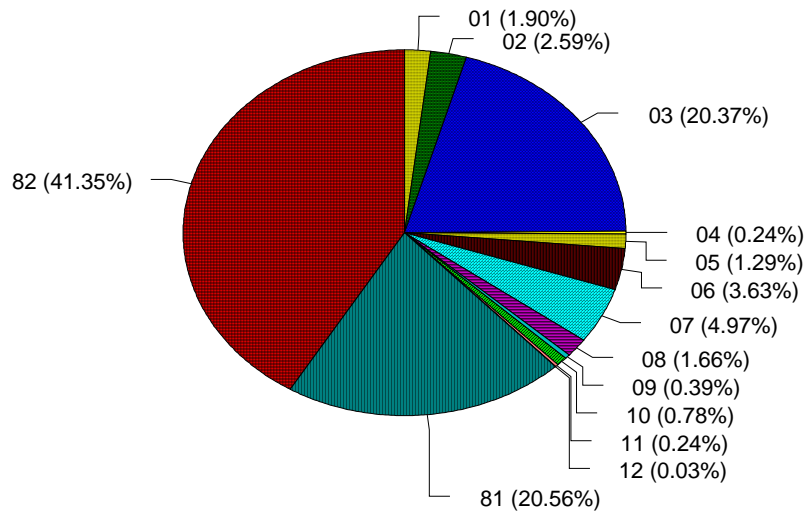


EXHIBIT 9

\$ Variance - 4/30 YTD



01	Design Error	08	Sales concession
02	Estimate change / error	09	Code change
03	Site condition	10	Backlog sub
04	Equipment rental	11	Weather conditions
05	Back charge	12	Vendor error
06	Theft / vandalism	81	Purchasing change / error
07	Rework & repair	82	PO not issued