

Net Profit Margin vs. Net Profit Markup

The final component to your prices is a **profit margin**. You need to price your work using an expected profit margin. If you've built an operating budget, your **Net Profit Margin**, as shown on your forecast profit and loss statement is a good start, but your margin doesn't have to match that number. Your margin can be lower or higher, depending on the situation.

When you are thinking about profit, remember that every job needs careful attention to this factor. Competitive jobs with many bidders typically have lower profit margins than custom design-build work. You will often find yourself pricing some work at one profit margin, and other work at a different profit margin.

Remember: When you are lowering your prices, you are **lowering your profit**. You need to be firm on the costs as defined in your estimate. Don't be tempted to mentally 'beat' your estimates while at the negotiating table. 9 times out of 10, your job will finish as estimated (or worse!), and the profit you thought you'd earn by beating the estimate will remain in your customer's pocket, not yours!

There are two easy steps to add a net profit margin.

1. **Select a net profit margin**
2. **Add this net profit margin to your job costs + overhead cost recovery**

The formula to add a net profit margin to a bid looks like this:

$$\frac{\text{Total Cost (\$)}}{(1 - \text{Desired net profit margin (\%)})} = \text{Price to customer (\$)}$$

Let's look at a simple example. We have a job where the total costs of the job, including all job costs and our overhead cost recovery markups, **totals \$18,000**. We want to make a **10% net profit margin**. The formula to calculate the price we need to charge our customer looks like this:

Start by filling in the information you know. The total costs go on the top of the equation. The profit margin you desire goes on the bottom of the equation (**don't forget to express profit margin in the form of a decimal**)

$$\frac{\$18,000}{(1 - .10)}$$

Before you divide your numbers, calculate the bottom of your equation. 1 minus .1 = .9. Now you're ready to divide.

$$\frac{\$18,000}{.9} = \$20,000$$

And it's that simple. To earn 10% profit on \$18,000, you need to charge your customer **\$20,000** for the work.

Why do I need to calculate my margin differently than my markup?

When we calculated markups, we simply multiplied the cost by 1 + the markup percentage. So then why are we **dividing** to calculate a profit margin?

The answer is because there is a difference between a **markup** and a **margin**. A markup is specific to the **cost** of the item. A margin is specific to the **price** of the item. Let's look at what would happen to our example above if we tried to use the multiplication formula:

Our costs were \$18,000 and we wanted a 10% profit margin.

$$\$18,000 \times 1.1 = \$19,800.$$

Notice the difference? When we calculated the profit margin using the margin formula (divide by 1 - desired profit margin) our price was \$20,000.

The formula to calculate a profit margin is:

$$\frac{(\text{Selling Price} - \text{Cost})}{\text{Selling Price}} = \frac{(\$20,000 - \$18,000)}{\$20,000} = .1 \text{ or } 10\%$$

We can see by this equation that our formula for profit margin (using division) and our formula for a markup (using multiplication) came up a bit short.

Why did this happen? Because the markup formula calculates 10% of the **cost** and adds it to the total costs. To calculate a profit **margin**, you want to add 10% of the eventual selling price to the cost. The margin formula enables you to do this.