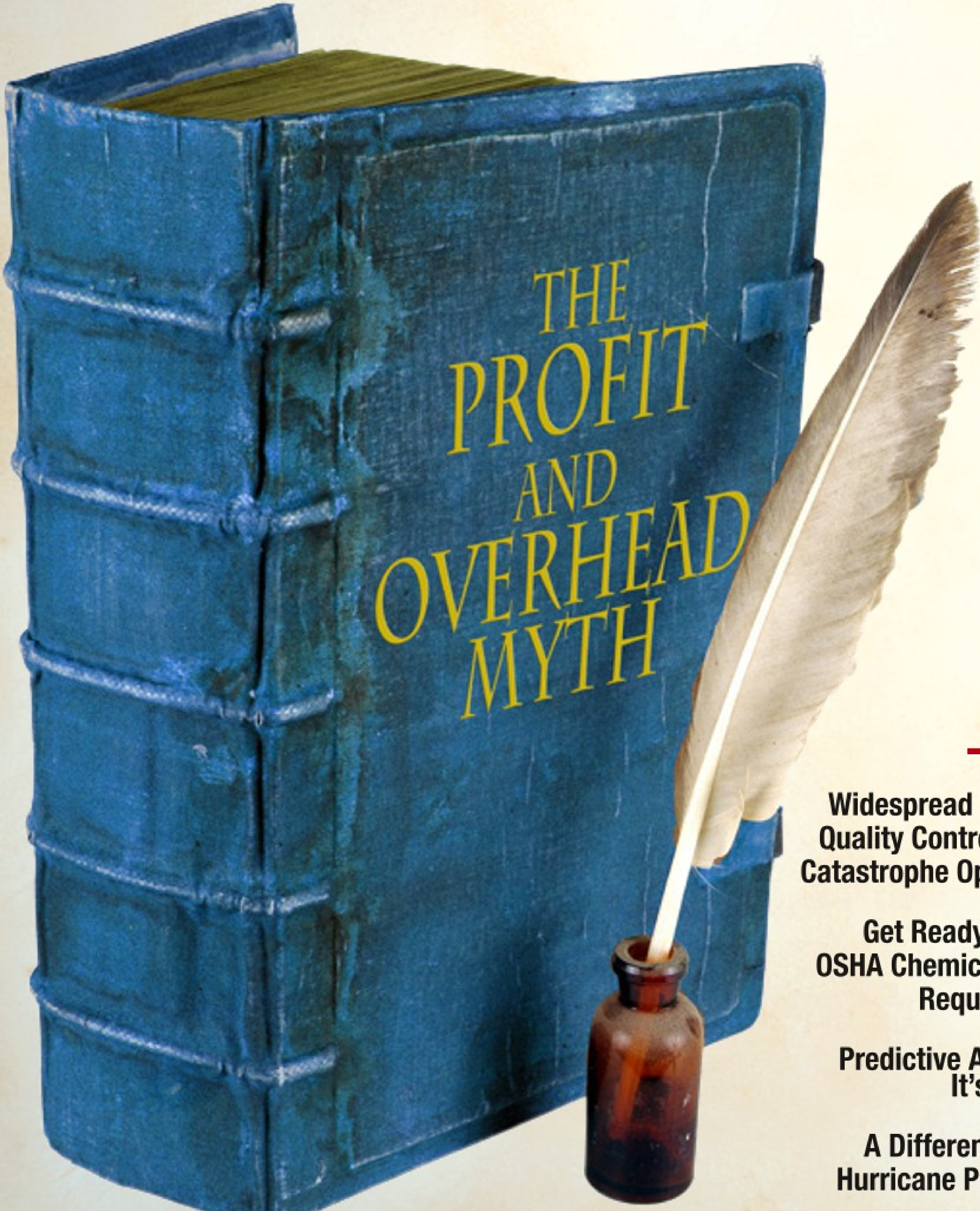
$9.00

Cleaning & Restoration

August 2012 • Vol. 49 No. 7

Published by the Restoration Industry Association

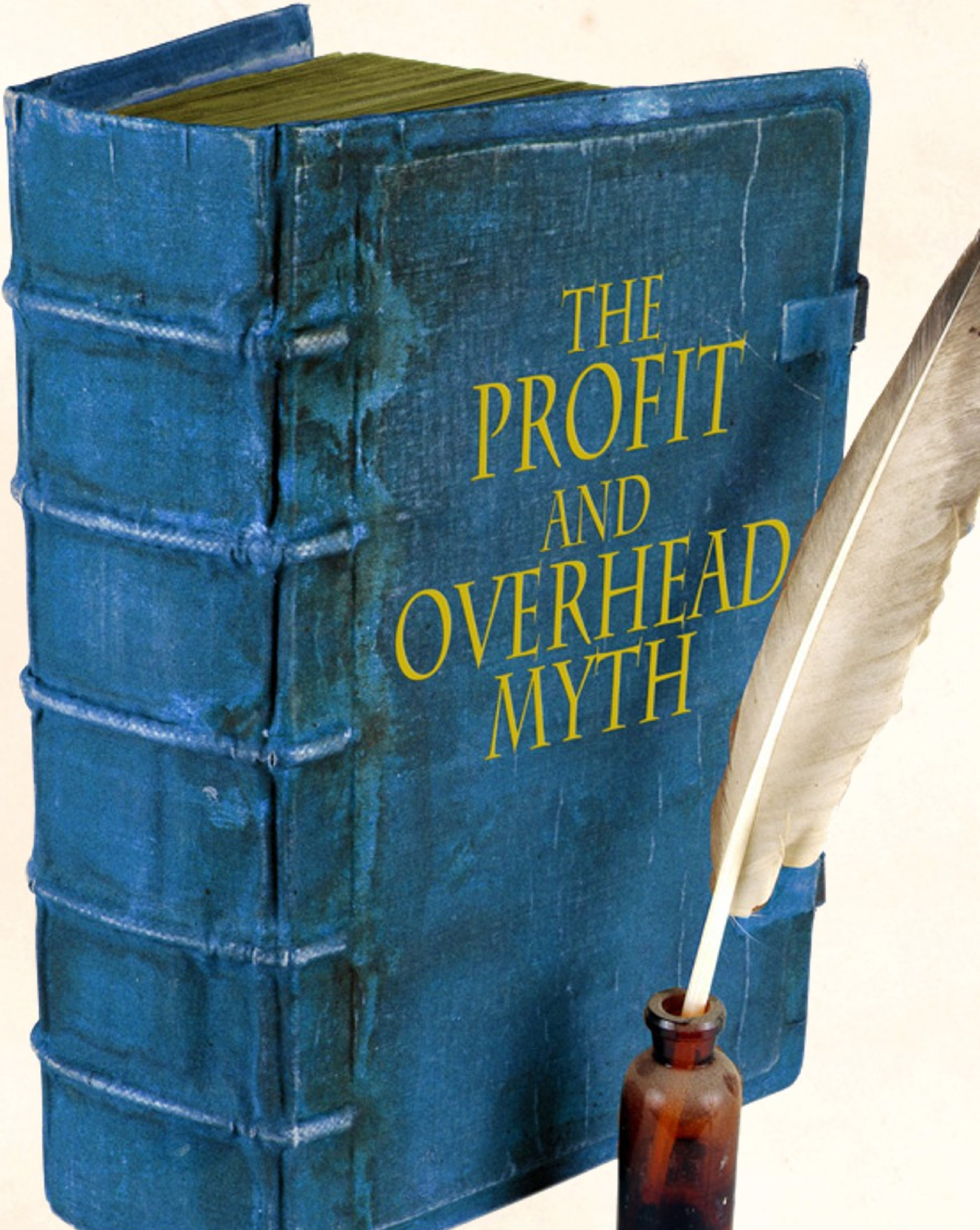


Widespread Disaster: Quality Control During Catastrophe Operations

Get Ready for New OSHA Chemical Safety Requirements

Predictive Analytics: It's Coming

A Different Kind of Hurricane Protection


THE
PROFIT
AND
OVERHEAD
MYTH

Pitfalls of the Current System Create Mistrust Between Restorers and Insurers

By Tracy Bachtell

Editor's Note: This article is based on a presentation from the "Closing the Gap" discussion at the RIA Leadership Summit earlier this year.

As insurers and restorers collaborate to manage the challenges they face when working together for their common customers, they are finding that the key to this conundrum is transparency. *The World English Dictionary* defines *transparent* as: "Easy to see through, understand, or recognize; obvious, candid, open, frank."

In an exchange between a restorer and an insurer, perhaps a better way of expressing transparency is as a tool used to build and preserve trust. Think about how much simpler our work would be if each party not only committed to, but practiced in an honest, open and ethical environment.

Each party has a vested interest in the successful outcome of any property claim. The insurer wants a policyholder to receive exceptional service, but only to the extent that the settlement is within the parameters of its estimating guidelines and service level agreements. The restorer wants the customer to promote the company to his or her neighbors and through social media, but the restorer also needs to make enough money to pay expenses and hopefully eke out a reasonable profit. This sounds so simple but alas, it is not.

This is due to a lack of trust. Neither party really trusts one another to the point where they can be transparent. The goal is for the insurer to be confident that it has paid a fair price and the restorer to be confident that it makes a reasonable profit. This can occur only when the job is managed well. Nobody expects the other side to take on risks that are not their own. But for whatever reason, the history behind the relationship between restorer and insurer got off track somewhere. Untested suppositions became protocols. Unfair business practices became easily rationalized as the only way to stay in business.

The purpose of this position paper is to focus on our collective failure to be transparent, to provide this history lesson alongside current facts and comparisons, taking us to a place where we can work together more favorably and, someday, perhaps be more transparent. We need each other. We have the same customer. It's potentially a win-win-win!

TOO MUCH PROFIT?

According to the National Association of Home Builders, the builders' average profit margin on a house is approximately 5 percent. According to NAIC data compiled by SNL Financial, the national average profit margin for carriers writing homeowner insurance for the past 10 years is 4.5 percent. As is evident, neither industry is particularly stellar in making excessive profits. Insurance restoration, which is almost exclusively what Paul Davis Restoration contractors do for a living, is not overly profitable.

Virtually every for-profit business runs with a similar expense load of approximately 35 percent. This is true of the insurance industry as well as the restoration industry. In fact, the adjusted loss ratio for the past 10 years for all homeowner carriers in the United States has been 63.5 percent. To make a net profit margin of 4.5 percent, they have had to manage their expenses.

In the insurance world, expenses are either allocated or unallocated. But when combined with underwriting expenses, we arrive at what the restoration world would compare to our direct and indirect labor costs and our job-specific and general overhead charges.

As confusing as this may sound, the decision to do work for a certain price or protocol is really based on the market conditions and individual choice.

WHAT DETERMINES THE MARKET?

The property insurance claim industry may be one of the best examples of free enterprise at work. Each insurance company develops its own protocols and pricing programs and usually offers them to the restorers on a take-it-or-leave-it basis. Here are some examples that are very familiar to restorers and maybe similarly familiar to the claims people. Since Xactimate is the most commonly used pricing software, my examples will focus mostly on them. Keep in mind that Xactware considers its organization to be a survey and publishing company. It does not set prices; it only publishes them based on its market surveys. It does not recommend the use of protocols, regardless of what we often hear. Those choices are left strictly to the insurers.

Base service charges were developed by Xactware years ago to reduce the use of multiple trade minimums while accounting for the mobilization costs incurred by restoration contractors. Some carriers prefer that they are factored in to unit costs. Some carriers prefer that they be broken out. Others forbid their use at all.

OVERHEAD AND PROFIT: "THE FOLLY OF 10 AND 10"

Ah, the mystery numbers. Restorers often refer to the 10 and 10 puzzle as "the folly of 10 and 10."

The history of overhead and profit being pegged at 10 and 10 dates back to when unit costs were created as a better way to construct estimates. This occurred long before there were computerized estimating systems and commonality in estimating practices.

Previously, written estimates often contained only one or two lines, as the contractors did not have fancy accounting tools to assess their business model. Over history, contractors learned if they took their material charges, then doubled them and added in their labor costs, they would make a small profit.

In those days, labor and material were roughly equal, so this method returned a gross margin of 33.3 percent. It was difficult for adjusters to write estimates, and unit costs made for much better production and easier training.

In those early days, unit costs came in two forms. One was the pure unit cost that combined only labor and materials. Then there was the full unit cost that included labor, materials profit and overhead. Later, a hybrid was created that included labor, materials and job-specific overheads but without general overhead or profit. No serious analysis was done to decide what overhead or profit should be. But the authors of the first tools on the subject mildly suggested that a 10 percent profit seemed palatable and tried to deduce what the overhead needed to be to return the 10 percent profit.

Formerly, contractors doing small insurance jobs often worked out of their homes. They may have had a single pick-up truck. They needed little, if any, insurance. They did not concern themselves with workers compensation or OSHA rules. Of course, insurers were similarly unburdened with many of the rules and regulations they deal with today. Competition set the market for them. Everyone's overhead was less.

Even if one assumes that somehow the historic guidelines of 10 and 10 are still useful, I want to bring everyone back to market value as the actual measure. Consider the various overhead and profit protocols that exist today.

Many carriers allow the addition of 10 and 10 when three or more trades are used. The thought is that the management of multiple trades creates more overhead. Some prefer not to make a blanket statement and leave it up to the individual adjuster to resolve and the restoration contractor to "plead for." Most carriers do not allow the addition of 10 and 10 on emergency service claims or single-trade losses involving wind and hail, the two most common annual claims for property insurers.

So, what does this all mean? In a free market system, the buyer and the seller have equal standing. The application of minimum charges, base service charges and/or profit and overhead are just techniques to manipulate the total price of the estimate. They have little impact on the cost of the job.

When agreeing to participate in an insurance program, the restoration contractor must make a business decision of whether or not to accept the terms of the estimating protocol. It is one of the truest open-market systems we have. There are enough insurers, and although a few have significant market share, no one has enough to control the market. There are enough restoration contractors vying for the work that someone will usually step up and take on the job at the price offered.

SCOPING ISSUES AND HIDDEN DISCOUNTS

As any experienced contractor or adjuster knows, unit prices are just one part of the estimating process. The other part is referred to as "scope." Scope is defined as what has to be done to put the policyholder's property back into a pre-loss condition. An experienced estimator can manipulate the scope to account for pricing protocols that seem onerous to have a job provide enough money to cover overhead costs and return sufficient profit.

This is wrong and no restoration organization should promote, accept or allow this. Experienced adjusters can inspect or re-inspect a property loss and find the "scope creep" and push to control or reduce it, but this task is only required because of the lack of proper scoping. Restoration contractors often use subcontractors; most insurance companies allow 10 and 10 on subcontractor charges. I am speculating that the reason is based on the understanding that the subcontractor charges are exactly what the general contractor has to pay for the work.

As general contractors have to be responsible for coordination, supervision and warranty for the work done by the subcontractor, they are entitled to be compensated for this. Of course, as I have tried to establish previously, 10 and 10 in no way allows the general contractor to make a profit. In fact 10 and 10, or 20 percent, only provides for a gross margin of 16.7 percent (20/120), nowhere near enough to provide the required gross margin of 33 percent to 35 percent.

So how are contractors able to increase their gross margins to what they need to survive when using subcontractors? Two common methods are used. The first—and the one that Paul Davis supports—is to use Xactimate for all estimating, whether the work is to be done by employees or subcontractors. Xactimate pricing reflects the market (or at least purports to).

The other commonly used method is based on the theory of wholesale and retail pricing used by many industries. In this method, the insurer is presented with a retail invoice, which is later marked up by 10 and 10. The restoration contractor pays the subcontractor based on a wholesale price, which may be several percentage points less than the retail invoice. Paul Davis considers this second approach reasonable if and only if the insurer is provided both invoices in a fully transparent fashion.

WORKING TOGETHER PROFITABLY

How can insurance companies and restoration contractors align their interests? We are in the age of information. With information naturally comes transparency. But more importantly, we can work together with mutual cooperation and transparency and as partners based on trust. If we are willing to see the perspectives of all stakeholders in the process, insurers and restoration contractors can be partners, leaving the historical realm of vendee and vendor.

Insurers want the best product and service for their policyholders. In the long run, restorers will work for those insurers that pay them fairly and will shy away from those that do not. Work volume is always a factor. In the true Walmart model, lower margins with higher inventory turns can work.

Unfortunately, standard work and operational efficiencies go only so far in the restoration industry. One of the reasons that our industry is so heavily franchised is the need to use a tried-and-true business model that recognizes the costs of business and can help the owners earn a net profit at the end of the day.

At the point that restorers lose money on their jobs, they must reject the referrals that come from insurers that are unwilling to pay fairly. I may be naïve, but I believe everyone prefers to sleep well at night and like what they see when they look into the mirror in the morning. Public adjusters and trial attorneys are attacking the current model we use.

Third-party administrators, such as Contractor Connection, Alacrity and Innovation Property Network, provide valuable services to insurers, such as contractor vetting, service level metrics and national territory coverage. They also review restorers' estimates in an effort to keep expenses in line.

Nobody disputes that estimate reviews add both to the cycle time and to the overall claim processing expense. The question really comes down to who pays for it. I would argue everybody pays. Whether it is a public adjuster, a trial attorney or a third-party administrator, each of these entities adds cost to the process without always providing an equal benefit to the end customer.

Unfair business practices can be rationalized, but they cannot be forgotten. Both the insurers and the restoration industry have made the bed that both must sleep in. The real downside is that this friction only adds cost to the overall claim processing expense, which would be unnecessary if more transparent processes were used. Maybe someday, we will truly put the policyholder first and work together to make sure we can both survive and prosper in this industry.

Tracy Bachtell is senior vice president of business development at Paul Davis Restoration. He is also responsible for the Large Loss, Commercial Loss and Catastrophe divisions. He joined the company in 2003 after more than 25 years in the insurance industry. He has earned both his Associate in Claims and CPCU designations and written several articles for Claims Magazine *on various industry topics.*