Building a Custom Home 101:

Construction Contracts

DALEY DESIGN + BUILD

Written by Russell Hausfeld • Photography provided by Daley Design + Build

Most of us do not spend our time planning out construction deals for new custom homes. So, when someone decides they want to build their dream home, most people begin the process at a disadvantage. Graeme Daley, founder of Daley Design + Build, believes that one of the best ways people can arm themselves before beginning the custom home building process is to have a basic understanding of the different construction contract arrangements that may be offered by builders and which one suits their wants and needs.

GUARANTEED MAXIMUM PRICE

In this deal structure, a client signs a construction contract at a specific dollar amount for a house with a set of design plans and preliminary specifications, factoring in a margin for the builder's construction management and potential complications. For production builders (25-40+ homes / year) and semi-custom builders (10-25 homes / year) this margin is often around 18% to 25% of the total project cost to build, according to Daley. Smaller custom builders (4-10 homes / year) working on higher priced homes can function on smaller margins from 15% to 18%.

"So, you sign up for $800,000 and, in theory, you're going to pay $800,000," Daley said. "That is great until you get to a scenario where the builder's budget has allowances – which are sums of money earmarked for specific selections categories like cabinets, windows, flooring – that don't match up with the actual cost of your final selections."

If a builder put in a $30,000 allowance for cabinets, but the cabinets the client really wants are $50,000, then the client has to get their checkbook out to pay the difference resulting in the "guaranteed" price going up. Unless all the selections are made before the builder produces the Guaranteed Maximum Price, it is a guaranteed price for a nebulous object that may or may not be what the client had envisioned. Many times the client doesn't really find out the true number of what their new home will cost until they're a month away from closing on their new home.

PROS: Upfront all-in price feels good, and can put clients at ease with new construction. Construction is started quickly as final selections are made throughout the construction process as materials and products need to be ordered.

CONS: Upfront price is often exceeded due to budget category allowances that don't align with client expectations of products and/or finishes, which can lead to high client dissatisfaction. Total price often ratchets up during construction process, and final price is not known until the last month of construction. In the end, the "guaranteed" price is often not in fact a guaranteed price. Some builders will cut corners or use less quality materials during the construction process to minimize project costs and maximize profits.

FIXED FEE

In a Fixed Fee arrangement, a builder agrees to build a house at cost, plus a set builder fee. So, the house would cost whatever the invoices total, plus a set dollar amount for construction management. A Fixed Fee contract takes some of the financial risk out of the deal for the builder; so many builders would accept a Fixed Fee deal at a slightly lower margin than a Guaranteed Maximum Price deal.

A fixed fee sounds like a fair deal for all parties, but in a fixed fee deal a savvy client could game the builder, according to Daley. For example, a client could lock a builder in at a $90,000 fee to build a $750,000 home (a 12% margin). Then, once construction begins, the client could decide they want to upgrade many finishes and features of the house to cost much more than originally planned – say the cost to build increases to $990,000 from $750,000. In this scenario, the builder would be making a much smaller margin ($90,000 on $990,000), which represents a 9% margin (or 25% loss in revenue) for managing $240,000 in additional work.

PROS: Client knows exactly how much the builder will cost from the beginning. Builders will often work at a lower margin with a Fixed Fee, as the risk to the builder is lower than a Guaranteed Maximum Price contract.

CONS: Builder can lose revenue on jobs where client decides to upgrade finishes and features after fixed fee amount is negotiated. If builder ends up feeling like they are being taken advantage of, the quality of build or continued customer service could suffer.

COST-PLUS

Daley's business operates on an open-book, cost-plus contract arrangement. In this type of contract, there is a cost-plus builder's fee percentage applied to all construction costs associated with a custom build. Daley believes that an open book, cost-plus contract is the most honest and fair approach to construction projects. This open book approach allows the client to see all of the actual construction costs associated with the project, and avoids the client and builder negotiating the price of every change order and upgrade throughout the project.

Daley applies his cost-plus fee up to an agreed dollar amount outlined in his Residential Construction Contract; then, for unforeseen budget overages beyond that signed amount, the builder's fee percentage is reduced to get the client's project across the finish line as close to budget as possible. This fee reduction eliminates any incentive for the builder to overbuild simply to increase profits. Daley believes that his clients should be allowed to see all of the information about their project.

"It's their project, not mine," he says. "I am simply the designer and facilitator strategically guiding my clients' projects through the custom home building process."

Daley's mantra is "no secrets, no surprises," and his design + build process reflects this. Most builders ink a deal with a basic set of specs and allowances, then start building while the client continues to make the next set of selections. Daley Design + Build takes the client through the entire design phase, then bids out the whole project. So, when it comes to sign an actual construction contract, they already have bids from real suppliers and subcontractors – as opposed to predicted (or estimated) allowances based on general specifications.

"My intent is to have no allowances whatsoever at the time a construction deal is signed," Daley said. "Everything in the budget is a real number. Any time you have allowances and/or place holders, there is area for movement, and unexpected movement in the budget leads to dissatisfied customers."

With a more accurate idea of expected construction costs and the lower risk of a cost-plus deal, Daley is able to work within margins of around 10% to 12% on larger family homes and 12-14% for smaller lifestyle homes. For managing custom home construction projects, Daley Design + Build charges a smaller margin than many other builders, effectively saving the clients money, or getting them more house for the same amount of money spent.

PROS: Client and builder receive accurate overall pricing before construction starts and transparency about costs and profits. Less chance of being taken advantage of for both client and builder. Cost-plus contracts encourage building using "best practice" methods, as there is no financial benefit to the builder to cut any corners.

CONS: By bidding out the entire project up front, the client may find out their dream house costs more than they anticipated spending. However, the client finds out this critical information before building starts while they still have time to modify selections and/or tighten up the size of the new home to align their budget with their expectations. ❖

If you are looking to begin the process of constructing a custom home, contact Daley Design + Build for skilled and knowledgeable building project advice and production.

For more information, call 513.315.4447 or visit www.daleydb.com.