AGRI-FACTS
Practical Information for Alberta's Agriculture Industry

Revised September 2017 Agdex 845-1

Essentials of Pricing

The success of your business depends on your ability to make a profit. The right product price can secure the profit you desire, expand your customer base and support your overall business plan.

Not pricing your products effectively can reduce your profit, fail to attract the customers you want and make your company more vulnerable.

Setting the right prices for your products and services can often be a challenge for businesses. There are many options to consider in creating a profitable price, many ways to establish your price and many factors in the marketplace that will have an effect on your price setting.

This factsheet will help you in several important ways:

- understand how price and profitability are linked
- discover three ways to establish your price
- take steps to determine the best price for your products

> *The right product price can secure your profit*

How price and profitability are linked

One of the most common reasons a business fails is in not asking enough for its products and services. If you are starting a new business or introducing a new product, you might be tempted to enter the market with a discounted product price in the hopes of gaining profits back through volume. This approach may not be the wisest course because without sustained profits, you will not be in business for long.

A product's price can have a huge effect on your business's success or failure. The price must be low enough that your customers see value, but high enough so that you earn a profit. If the price is too high, you may struggle to sell your product. If you set the price lower than consumers would be willing to pay, you could be leaving valuable revenue on the table.

To succeed, you will need to find that win-win scenario that offers your product or service in a way that brings value to your customer while at the same time making a profit that allows you to continue creating your products. Find that sweet spot by understanding key factors:

- what your customer is willing to spend for products like yours
- who your competitors are, what they offer and the marketplace you operate in
- your costs of production and other expenses that can affect profitability
- which market channel you will use and how pricing strategies vary with each channel
- the best method for your business for arriving at your product's price
- how your price may change over time as changes in your customer groups or marketplace occur

If you have created a company business plan, you may already have some of this information at your fingertips. For more information on creating a business plan, the web post called "Elements of a Business Plan" on the Alberta Agriculture and Forestry (AAF) website details information on the subject.

Three different ways to establish your price

As you review each pricing method, think about your business, your industry and your customers. Understand each option available and the advantages and disadvantages of each. Pricing methods are explained in greater detail in the AAF factsheet Methods to Price Your Product (Agdex 845-2).

Here is a quick overview of the three most common ways of determining a price for your product or service.

Cost-based pricing

Cost-based pricing involves figuring out what it costs you to make your product and then adding a percentage or price amount mark-up (profit) to determine the final price. With cost-based pricing, it is important to consider all your costs of producing the product, including raw materials, your time, what you pay others to produce the product and your business's operating costs.

Competition-based pricing

Competition-based pricing is where the seller uses the price of competing products as a benchmark to set their own product's price. This method is typically used when you are producing a commodity product that is similar to the competition's product. When using competition-based pricing, you still need to cover your cost of producing your product.

Customer-based pricing

Customer-based pricing (also known as value-based pricing) involves setting the price based on customer "demand," taking into account your customers' perceived value of the product. Customer-based pricing requires businesses to have in-depth knowledge of their customers' needs. If your product is unique, a customer-based price may be a more profitable option for your business

Essential steps to pricing your products

Step 1: Know your customers
Step 2: Identify relevant substitutions in your market
Step 3: Determine your cost of production
Step 4: Understand how distribution affects pricing
Step 5: Select your product pricing method
Step 6: Review your pricing strategies regularly

Step 1: Know your customers

Knowing as much as you can about your "ideal customer" is an essential part of your business. The better you understand the wants, needs, beliefs and values of your customer, the easier it is to accurately price your product.

Take time to create a profile of the ideal customer who will buy your product and is likely to make repeat purchases. You might decide to attract a broad customer base with general characteristics or a narrow target group with unique factors.

The first step in identifying your target market is understanding what your products/services offer to that target group. In your customer profile, include a list of *features* as well as *benefits* a potential customer will gain by using your product or service. For example, the flavours or size of containers for yogurt are its *features* while the *benefits* are the nutritional advantages in the way yogurt promotes digestive health.

Next, define your target market by categorizing your list of potential customers into strong segments of similar characteristics. A group of consumers with similar characteristics, such as families with young children, is an example of an audience segment. If you are selling a nutritious snack, rather than targeting everyone, you might consider targeting parents who want healthier school lunches for their children.

Here are some examples of the different ways to categorize your target audiences:

- geographical location, climate or region
- demographics such as gender, age, income, education
- family size
- spending patterns
- leisure habits
- attitudes, values or lifestyle

When preparing your product's targeted customer segment, include as much detail as you can. You might need to conduct market research to fully define your target customer's characteristics. For more information on conducting market research for this important step, see the AAF factsheet Market Research (Agdex 848-6).

Step 2: Identify relevant substitutions in your market

Substitutions are similar products for sale in the marketplace that your target customer can switch to if they believe your product no longer offers value. Create a list of substitutions available to your potential customers and their price, before you set your product price.

For example, if you sell carrots through a farmers' market, substitutions might include specialty carrots (e.g. organic or baby carrots), but also other vegetables such as corn, peas, parsnips and beans.

Step 3: Determine your cost of production

Knowing your cost of production is an important building block for the economics and management of your business. This knowledge is also key to setting your price.

To calculate your cost of production, follow these three steps:

1. Understand how much it costs to make your product by keeping accurate, detailed records. Include *all* your costs, which means raw materials or ingredients, your time, paid labour and your business overhead expenses (e.g. transportation, marketing, utilities).
2. Use your detailed inventory records to figure out how much you produce throughout the year. If you operate a business where production varies throughout the year, project your output monthly.
3. Calculate a cost to produce, store and sell one unit of product, including all fixed and variable costs. To arrive at a per-unit cost of production, divide your total production costs by the number of units produced. If you use seasonal pricing, include the different per-unit costs for periods in the year when prices may change.

For more information on determining your cost of production, review the video "An Introduction to Cost of Production" on the AAF website.

Step 4: Understand how distribution affects pricing

There are many different market channels for agriculture-based businesses. Decisions on how you market and distribute your product can influence which pricing method you select. Think about your target market when you select a channel.

Here are some examples of market channels:

- selling direct to customers through local farmers' markets
- selling through a retailer or retail chain
- selling direct to a restaurant
- selling to a broker who takes responsibility for sales to customers

The channel you select will affect your pricing. For example, when selling direct to the consumer through a farmers' market, the price the customer pays is your revenue. When you sell to a retailer or through a distributor, these agents will keep a considerable portion of the retail price. Depending on your choice of channel, your profitability may not be determined by the price a customer pays the retailer, but by the price the wholesaler pays you.

Many new business owners keep start-up costs low by distributing the product themselves. As the business grows, you can decide to use several market channels to reach different customer groups. Regardless of how your distribution is handled, always include your distribution costs in the calculation of your cost of production, as outlined in Step 3.

Step 5: Select your product pricing method

By this stage in the process, you should have enough information to set your price. As mentioned above, there are three types of pricing strategies: cost-based pricing, competition-based pricing and customer-based pricing. Choose the pricing method that best suits your overall business goals.

Step 6: Review your pricing strategies regularly

Although keeping your price consistent can build loyalty among your customers, the price does not have to be set in stone. Monitoring your pricing over time is a smart business practice. As your company grows, or if you make changes to your distribution or you experience significant changes or opportunities in the marketplace, review your price to ensure you are still making a profit.

Here are some ways to ensure your pricing stays relevant:

- ask your customers for feedback on your products, price and value
- track your competition and any changes they may be making to their pricing
- monitor changes in the marketplace that may affect your prices

- review your pricing method when you have made significant changes to your business
- review your sales to determine if you can charge more or should be charging less
- review your cost of production to see if changes are needed to ensure your profit

Resources

The following resources, tools and business templates may be of value in starting and growing your business. Most are Agdex factsheets and all can be found on the AAF website.

Methods to Price Your Product (Agdex 845-2)

Pricing Processed Food Products (Agdex 845-3)

Pricing Horticulture Products (Agdex 845-4)

Pricing Meats Products: An Introduction (Agdex 845-25)

Identify your Market – Right Buyer, Right Price (Step Three) (Agdex-811-10)

Market Research (Agdex 848-6)

Business Basics for Alberta Food Processors (Agdex 845-11)

Pricing Terms and Definitions – Understanding how to price your products begins with understanding the terminology used (search the title on the "Biz Info" pages of the AF website).

For further information, contact an Alberta Agriculture and Forestry New Venture Specialist toll-free at 310-FARM (3276).

Prepared by

Alberta Agriculture and Forestry

More information, contact

Alberta Ag-Info Centre
Call toll free: 310-FARM (3276)

Website: agriculture.alberta.ca

The development of this factsheet was supported in part by *Growing Forward 2, a federal-provincial-territorial initiative.*