AGRI-FACTS
Practical Information for Alberta's Agriculture Industry

Revised September 2009 Agdex 845-1

The Essentials of Pricing

You have worked hard to test, develop and package a unique line of products. Now it's time to set prices for all your products. Setting a price for products is a challenging job for both start-up and established businesses. It's an important task since the success of your business relies on your ability to make a profit.

Setting Prices for Profitability

The price of a product can make the difference between success and failure! Pricing should be in line with the perceived 'value' of the benefits your product provides its customers, while also keeping in mind competitor pricing, market trends and customer demand.

Three factors are essential in pricing – the **cost**, **price** and **value** of your product.

The cost is the amount you spend to produce the product (total cost).

The price is your financial return or reward for creating the product.

The value is what your customer believes the product is worth to them.

To maximize your profitability focus on value-based pricing.

Value-based pricing - Prices are set based on the perceived value to the customer, rather than just the cost of the product, the market price, or competitors' prices. Value-based pricing enables companies to become more competitive and profitable than when using simpler pricing methods. This is because value-based pricing is dependent on processors knowing their customers' needs, their perceived value of a product and how customers determine value through the benefits of the product.

To better understand a customer's perceived value, and ultimately to set a price, you have to first consider the entire innovation cycle of a product or business - from concept to commercialization. There is a sequence of definable steps or stages that can be used to break down this process.

The following table is an abbreviated summary of the steps and stages of the concept to commercialization cycle.

Use this as a tool to help you develop and price your products.

Concept to Commercialization

Stage One Idea Generation	Stage Two Concept Verification	Stage Three Market Test	Stage Four Pre-launch Strategies	Stage Five Launch
1. Concept development – what problem does the product solve? Or what benefit does the product deliver that is unique? 2. Assessing your idea – is there a 'need' or gap your product will fill?	3. Confirm there is a need, e.g. market research or pre-feasibility study. 4. Idea screening – present your product to a few potential buyers. 5. Product refinement – are there product changes required? 6. Define the product benefits from the customer's viewpoint.	7. Define your ideal customer. 8. Develop a small batch of products. 9. Present the products to potential buyers. 10. Determine if there is adequate buyer interest. 11. Determine your break-even pricing. 12. Determine your profitability goals.	13. Develop a marketing mix to reach your ideal customer. 14. Complete a due-diligence assessment, e.g. review relevant regulations. 15. Complete an operations budget. 16. Develop a marketing plan and/or a business plan.	17. Commercialization – implement the marketing plan.

Government of Alberta

The steps involved for planning the price of your product include components that you also need to develop a business plan. Keep notes and files as you go through each of the steps. By the time you have set a price for your product you will have information on your:

- customer
- market
- competitors
- costs
- distribution strategy

This information is useful when you write your business plan.

To set the best price for your product you need to review the essentials of your business evaluating how they affect price.

Essential steps to planning your product's price are to:

Step 1 – Know your customer
Step 2 – Identify substitutions
Step 3 – Determine the cost of production
Step 4 – Develop and cost a marketing plan
Step 5 – Design and cost a distribution strategy
Step 6 – Research product pricing methods

The customer is an essential element of your business. Take the time to design a target customer profile. A target customer is your ideal customer. It is also important to know what other products compete for your customers' interest and dollar, as well as which products are interchangeable with yours. Search for all the substitutes your customer could switch to and keep an up-to-date list of them. An example of a substitute is margarine for butter.

Do you know how much it costs to make your product(s)? Prices must go beyond break-even to include a profit. Design your marketing plan to ensure your target customer knows about your product. Select a distribution plan that efficiently connects your product with the customer. An understanding of pricing methods and how they can be used provides more pricing options.

Step 1 – Know Your Customer

The better you understand the wants, needs, beliefs and values of your customer, the easier it is to accurately price your product. A target customer profile is an important first step in pricing. A target customer is the person who buys your product and is likely to make repeat purchases. You may 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 have to offer to a group of people or businesses.

To do this, identify your product or service's features and benefits. A feature is a characteristic of a product/service that automatically comes with it. Features "belong" to the product or service.

Example
If a toothpaste has a stain-removing formula, that's a feature. The benefit to the customer, however, is whiter teeth as well as cavity-fighting agents.

While features are valuable and can certainly enhance your product, benefits motivate people to buy. Benefits are what the potential customer will gain by using the product or service.

Example
When it comes to yogurt, the flavours or size of containers are features, while the benefits are the nutritional benefits of yogurt and the promotion of digestive health.

By knowing what your product/service has to offer, and what will make customers buy, you can begin to identify common characteristics of your potential market. Each target market perceives value slightly different—this ultimately determines a price point or profitability for your product.

Example
There are many different consumers who desire food to provide healthy benefits. Rather than targeting everyone in your promotional strategy, consider targeting mothers who are shopping for healthy-for-you school lunches for their children. A group of consumers with similar characteristics, such as families with young children, is an example of market segmentation.

To define your target market, you must understand the following about your customers:

- where they live
- age
- education
- family size
- spending patterns
- leisure habits
- needs

To prepare a target customer profile, include as much detail as you can. You will need to conduct market research to fully define target customer characteristics. Market research can be done using two different methods: primary data and secondary data.

Primary data uses detailed methods to provide tailored information about the wants and values of your customers. It's usually expensive as most business owners find they must hire a market research professional to design the research method and to interpret the data.

Secondary data is compiled from existing materials and research. It's more general, but can often give you the insight you need about the industry, key contacts and customer characteristics. Most business owners find they can conduct their own secondary data research.

Example
A farmers' market vendor can use the Alberta Agriculture and Rural Development study, Farmers' Markets in Alberta - A Direct Channel of Distribution, to profile a target customer. After reading the study, the vendor knows the target customer is a 25 to 46-year-old female. The target customer is loyal to the market and visits it regularly to buy vegetables, baked goods and meat products.

Many customers visit a specific vendor each time. The wants of this target customer are freshness, product quality and to support local farmers and the community. You can gather your own primary data by booking a stall at the farmers' market for a month or two. Use this time as an opportunity to talk to your potential customers. Ask about what's important to them, prices, why they shop at the market, etc.

Step 2 – Identify Substitutions

The number of substitutions available on the market and their price must be considered before you set your product price. Substitutions are similar products for sale in the marketplace. Your target customer may decide to switch to a similar product or substitute if they believe your product no longer offers value.

Example
If you plan to grow carrots and market them through several farmers' markets you should scout these markets and prepare a list of other vegetables or substitutions available for sale. Be sure your list of substitutes is complete. A list of substitutions for carrots could include other varieties of specialty carrots (e.g. organic or baby carrots), corn, peas, parsnips, beans and a number of other vegetables that could be used as a cooked vegetable. If your carrots are used in salads, other vegetables could be used instead. Remember, if people want carrots, they buy carrots. If you process a specialty product like birch syrup, all other pancake syrups are considered substitutes.

Step 3 – Determine Cost of Production

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

1. You need to know how much it costs to make the product. To do this you need accurate, detailed bookkeeping records. Include all costs,; raw materials, labour and overhead for a total cost of production.
2. You must know how much you produce throughout the year. Detailed inventory records provide this information.
3. You need to calculate a per unit cost. A per unit cost is the cost incurred to produce, store and sell one unit of product including all fixed and variable costs. If you plan to use seasonal pricing, then calculate various per unit costs for the periods in the year when prices are bound to change. If you are the first at the start of the season to have new potatoes for sale, you can charge a premium for your product. Your target customer is likely willing to pay extra for the freshness and quality.

Per unit cost of production: total production costs divided by number of units produced

People planning a start-up business need to research the costs of inputs (raw material, ingredients, labor and equipment). You need to project how much you plan to produce to break even (cover production costs before profit) and how much profit you wish to make. If you operate a business where production varies throughout the year, be sure to project output on a monthly basis. A per unit cost estimate can be projected using cost estimates and output projections.

Step 4 – Develop and Cost a Marketing Plan

Marketing costs must be calculated on a per unit basis and included in the product cost. There are many ways to promote your product to target customers. The amount and types of marketing you decide to use can range from word of mouth to hiring a marketing firm that manages all aspects of an intensive marketing strategy. This means the cost of your marketing efforts can range from low to a substantial percentage of your costs.

To develop a marketing plan you need to set marketing objectives, describe your target customer and select a marketing mix. The marketing mix is often called the four Ps of marketing and refers to: price, products promotion and place (or the distribution channels).

Remember The Four Ps of Marketing!

Price

Product

Promotion

Place (distribution channels)

To prepare a marketing plan you need to research the various promotion methods available. This can be done by talking to other business owners, conducting a secondary research study on promotion methods and through interviewing firms that develop and manage promotion campaigns. The type of promotion you select should be based on your marketing objectives, the types of competition you face, the cost of marketing activities and how you plan to manage the other three Ps in the marketing mix.

The marketing plan should extend beyond the immediate year to include how you will market the product(s) for the next three to five years. A longer term plan is important if you plan to expand the promotion plan to grow your customer base. New businesses often use little or no promotion when they start-up because they cannot afford it. When you can afford it, promotion can be used to further refine your target market or create new markets.

Research the costs of your promotion strategy now and in the future. Calculate marketing costs on a per unit basis. Include promotion costs in your product price.

Per unit cost of marketing: total costs of marking divided by number of units produced

Step 5 – Design and Cost a Distribution Strategy

This step answers the question: How will I get my product or service to my target customer? The short answer to this question is to select the right channel(s) of distribution based on your product, customer and competition.

A channel of distribution links your product with your target customer. There are many types of market channels. They range from the local farmers' markets to selling directly to customers, or selling through a retailer or foodservice (restaurant) establishments. Selling your product to a broker who takes responsibility for sales to customers is another option.

Market channels give you plenty of flexibility. You can select one market channel or combine several into a distribution strategy. Remember to focus on your target market when you select a channel. Many new business owners keep start-up costs low by taking responsibility for product distribution. As the business grows you may decide to use several distribution channels to reach different customer groups. Like marketing and production, you need to research your distribution costs and calculate a per unit cost. Add the per unit distribution cost to other product costs.

Per unit cost of distribution: total distribution costs divided by number of units produced

Step 6 – Research Product Pricing Methods

This step helps you find an existing pricing method or design a pricing strategy to suit your business. The three types of pricing strategies are cost-based pricing, competition-based pricing and customer-based pricing. Each offers several choices on how you can set your price. Product pricing methods are explained in detail in the Alberta Agriculture and Rural Development's factsheet, Methods to Price Your Product (Agdex 845-2).

Product pricing is a big decision for any business owner. The right product price can earn the profit you desire, draw target customers and support your promotions plan. Incorrect prices can wipe out profit, annoy customers and hurt your reputation in the market. As discusseds earlier, value-based pricing focused on your customers' perceived value tends to be a more profitable option. Profit is the income left after all direct costs, labour and overhead expenses have been paid. Ensure you have factored in all direct costs all the way along your distribution channel before you set a price.

A decision with this much impact on your business deserves extra attention. Take the time to detail your target customer, research current substitutes and maintain cost of production records. Decisions on how you market and distribute your product affect which pricing method you select.

Resources

The following resources, tools, business templates may be of value in starting and growing your business "profitably."

- Methods to Price Your Product (Agdex 845-2)
- Pricing Processed Food Products (Agdex 845-3)
- Pricing Horticulture Products (Agdex 845-4)
- Marketing: Will It Sell? (Agdex-845-5)
- Market Research   (Agdex 845-6)
- Business Basics for Alberta Food Processors (Agdex 845-11)

The above are available from Alberta Agriculture and Rural Development's website at www.agriculture.alberta.ca/publications.

Biz Info –Starting and Growing a Business - available from www.agriculture.alberta.ca/bizinfo

For further information contact an Alberta Agriculture and Rural Development New Venture Specialist toll-free at 310-Farm (3276)

Glossary

Break-even point – where total revenue equals total costs not including profit.

Broker – a food broker is a sales agent hired by a producer, processor or manufacturer to encourage sales between a buyer and the seller.

Direct cost – costs that always exist, regardless of how much or how little you sell. They are costs that can be directly traced to producing a product, e.g., raw materials, ingredients, salary, etc.

Direct marketing – product moving from the farm/processors directly to the consumer and bypassing brokers, distributors or retail channels of trade.

Distribution channel/market channel – describes the route a product takes to reach the consumer/end-user, e.g., direct market channel, retail channel, etc.

Distributor – buys your product and resells it, at a profit, to his account. Distributors offer experience, contacts, and market segments such as gift stores, grocery chains, specialty food stores etc.

Economy of scale – the cost advantages and savings a processor gains when more product units are produced, e.g. purchasing raw materials in bulk reduces the input costs.

Farm gate sales – are sales made directly from the producer to the consumer/end-user, often on site at the farm, e.g. U-pick sales, on-farm sales.

Fixed costs – are consistent costs (overhead) that do not change from month to month. These costs occur no matter how many products are produced. Often they are time related, e.g. monthly rent, yearly real estate taxes, annual machinery costs, depreciation, salaries, etc.

Indirect costs – soft costs associated with production, e.g., real estate taxes, administration costs, overhead/lease/rent options, salaries, etc.

Input costs – includes direct costs (raw ingredients and material) and indirect costs (overhead, production costs, etc.) to produce a good.

Market segment – a group of consumers that have the same buying characteristics or have similar needs.

Market share – indicates the size of market one producer/company holds. To calculate market share you need to divide the amount of product you sell into the total market number.

Marketing mix – the combination of marketing strategies used to sell a product. The four main elements center around four functions, sometimes called the Four Ps: product, price, place (of distribution), and promotion.

Non-cash costs – do not involve an outlay of cash e.g. depreciation or amortization. Non-cash costs should be included in a product's cost.

Overhead costs – the ongoing expenses of operating a business, e.g., rent, repairs, utilities, insurance, salaries, etc.

Per unit cost – The cost incurred to produce, store and sell one unit of a product including all fixed costs (e.g., plant and equipment) and all variable costs (e.g., labour, materials, etc.) involved in production.

Primary data – detailed research methods such as interviews or actual buying patterns to provide tailored information about the wants and values of your customers.

Product bundling – is a marketing strategy where several products are for sale as one combined product, e.g., a Saskatoon liquor with a set of crystal glasses.

Product life cycle – a new product progresses through a sequence of stages, which generally include the introduction, growth, maturity and decline stage.

Production costs – the total cost of the product including raw materials, labour, overhead, distribution, etc.

Retail prices – the price charged to a consumer.

Secondary data – information from existing sources and materials already researched or reported on by another source.

Target market – the demographic group of consumers most likely to want or need to buy your product.

Variable costs – costs that increase proportionally to the amount produced. As a rule of thumb, variable costs include direct labour, direct material, equipment repairs, fuel costs for distribution, broker fees, marketing expenses, etc.

Wholesale prices – the price of a product before a middleman (distributor or broker or agent) or retailer has added on their mark-up fees to the price.

Wholesaler – a third party or firm that buys products from producers and processors to sell to food retailers and foodservice. Their main functions are to purchase, transport, sell, assemble, store and distribute.

References

Canadian Farm Business Management Council (CFBMC). Value-Added Products in Agriculture.

Agriculture and Agri-Food Canada. 2000.

Canadian Farm Business Management Council. Building Value through Farm Diversification.

Agriculture and Agri-Food Canada. 2004.

Klotz, Jennifer-Claire. How to Direct Market on the Internet. Diane Publishing Co. 2002.

Doman, Dennison, Doman. Look Before Your Leap. Market Research Made Easy. Self Counsel Business Series, Self Counsel Press. Vancouver, 1993.

Peter and Donnelly. A Preface to Marketing Management. Irwin, Boston. 1991.

Timmons, Jeffry A. New Venture Creation. Irwin, Boston. 1994.

Market Research - The How To. Alberta Agriculture, Food and Rural Development. June 1995.

Market Research - When You Need to Hire a Professional. Alberta Agriculture, Food and Rural Development. June 1995.

Market Research - Help and Where to Find It. Alberta Agriculture, Food and Rural Development. June 1995.

Farmers' Markets in Alberta - A Direct Channel of Distribution. AARI Report Project #95CR16. Department of Human Ecology, University of Alberta and Alberta Agriculture, Food and Rural Development. 1998.

RV 09/09/100