

Pricing Essentials

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.

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've set a price for your product you'll have information on your customer, your market, your competitors, your costs and your distribution strategy. This information is useful when you write a formal business plan to obtain financing.

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

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

- know your customer
- identify substitutions
- determine the cost of production
- develop and cost out a marketing plan
- design and cost out a distribution strategy
- research product pricing methods

The customer is an essential element of your business. Take the time to design a target customer profile. Search for all the substitutes your customer could switch to and keep an up-to-date list of them. 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.

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. The type of target customer you define depends upon your product. You may decide to attract a broad customer base with general characteristics or a narrow target group with unique factors.

To define your target market you must understand where the customer lives, their age, education, family size, spending patterns, leisure habits and 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 Swimming Pool contractor wants to know who to target in his marketing campaign. He may search the Internet and find a study published by the In-ground Pool Builders Association of America entitled, "Who's Buying Pools in California in 2006". After reading the study, the contractor learns that his ideal target customer is a 35 to 50 year-old male, married with children between the ages of 6-17. The target customer's spouse is also very likely to be employed. They live in a home worth more than \$300,000 and have a household income in excess of \$100,000. The primary "wants" of this target customer include attractive design, value-pricing, and quality construction. They also do not want to spend their precious time on pool cleaning and other maintenance so they want a pool system that is easy to use and self-maintained. Between the information in this study and what the contractor can gather from surveying his own customers and staff, he can find out a lot about what's important to prospective customers and other important details like prices, after-sale service, training on using the equipment, and long-term maintenance and care.

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 or best meets their needs.

Determine Cost of Production or providing your service/product

To calculate your cost of production, follow these three steps. First, you need to know how much it costs to make the product. To do this you need accurate, detailed bookkeeping records. Second, you must know how much you produce throughout the year. Detailed inventory records provide this information. Third, you need to calculate a per unit cost using "defined period" cost and output numbers.

People planning a start-up business need to research the costs of inputs, labor and equipment. You need to project how much you plan to produce or sale. If you operate a business where production or sales 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 for service and retail businesses as well.

Develop and Cost out a Marketing Plan

Marketing costs must be calculated on a "per unit of sales" basis and included in the

service/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. Marketing budgets typically range from 2% to as high as 15% of gross revenue/sales.

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. They are price, product, promotion and 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 services/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 can't 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.

Design and Cost out 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 use of a web-site, to a local retail store, to selling directly to customers. 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. 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 service/product costs.

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, competitive based pricing and customer based pricing. Each offers several choices in how you can set your

price. Product pricing methods are explained in detail in the Alliance SBDC factsheet, *Pricing Strategies: How to Price Your Products and Services*. 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 pricing can wipe-out profit, annoy customers and hurt your reputation in the market.

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 good business cost/expense records. Decisions on how you market, promote, and distribute your product affect which pricing method you select.

Glossary

Broad customer base - a large number of customers with more general characteristics.

Distribution channel/market channel - describes the methods you use to get your product from your production facility to the end-user

Marketing mix - a term used to describe the four Ps of marketing. The four Ps are price, product, promotion and place or distribution channels.

Narrow customer base - a smaller customer base with unique or similar characteristics.

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

Secondary data - information from existing materials that tends to provide general details on your industry, key contacts and customer characteristics.

Substitutions - the same or similar products to what you are selling that customers could chose. These usually refer to products offered by competitors.

Start-up - a stage in a new business where the owner(s) is establishing the means for the production, marketing, distribution and pricing of the product.

Target customers - the people who buy your product and are most likely to continue buying the product.

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