BUILDING NATIVE INDUSTRY INSTITUTE

PRICING YOUR PRODUCT OR SERVICE

Price Perceptions

The price of your product means more than numbers on a tag. Higher priced items are often perceived by consumers as having greater quality or being an exclusive luxury product. On the other hand, prices that are significantly lower than the competition create the perception that the item being sold is of lower quality. Many factors lead up to a consumer choosing your product or service over your competitors, so cutting prices will not necessarily lead to more customers. In fact, a strategy of underpricing or consistently cutting prices to beat the competition will actually lead to decreased sales. Hence, it is important to determine a price that is going to capture the majority of what your target market is willing to pay.

Pricing Strategies

There are no set rules for setting your price, but there are several methods that small business owners use to determine prices for their products or services. Following are three common strategies.

Cost-Plus Pricing

Cost-plus pricing is the simplest pricing method. To determine your cost-plus price, take the cost of raw materials and any fixed costs required to produce your product. Then add a profit margin on top of that. Let's say you own a bakery and would like to determine the cost of a dozen cookies. You will want to calculate the cost of all the ingredients, plus any other costs required to make the cookies, such as rent, utilities, or employee wages. You will also want to take into account any other overhead costs required to operate you business, including license fees, marketing costs, or insurance.

Since all of your fixed costs are most easily calculated on a monthly or yearly basis, you can use your forecasted sales volume to figure your price. For the sake of this exercise, let's say you plan on selling 1,000 dozen cookies per year. Your cost for your raw materials to make those cookies is $1,500, and our annual fixed costs are $3,500. That brings your total costs to $5,000 ($1,500 + $3,500) per year. At the sales rate of 1,000 per year, that means it takes you $5 ($5,000 ÷ $1,000) to produce a dozen cookies.

Now, let's say you want to operate at a 20% mark-up. Take $5 and multiply that by 1.2. That sets your price at $6 per dozen cookies.

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Target Return Pricing

Target return pricing is designed so that you can achieve a return on your investment within a certain time frame. Assume that you have $10,000 invested in your business, and your expected sales volume is 1,000 units in the first year. Your goal is to recoup all of your investment in the first year, so you need to make $10,000 in profits on 1,000 units. You know that you need to make $10 ($10,000 ÷ 1,000) in profit per unit.

To calculate your price, simply add $10 to your production costs. Remember to take into account costs for all of your raw materials, as well as your fixed costs. For this example, let's say your production cost per unit is $40. Using the target return pricing strategy, your price per unit would be $50 ($10 + $40).

Value-Based Pricing

Determining your value-based price means looking at the value your product or service brings to your customer. Value-based pricing is the most highly recommended technique and considered to be the most profitable, but figuring it is a subjective process. You need to have a solid understanding of your customers' needs as well as the competition that exists in the market. To figure your value-based price, follow these steps:

1. *Identify the price of your customer's second best option.* If they don't buy your product or service, then what are they choosing, and how much does it cost?
2. *Estimate the value your strengths bring to your customer.* List all of the ways you think your product or service is better than the item identified in step one. Estimate how much you think these differences are worth.
3. *Estimate how much your weaknesses decrease the value of your product or service.* Take an honest look at the second best choice on the market and list all the ways that this item is better than yours. Estimate how much you think these benefits are worth to your customers.
4. *Calculate your best price.* Take the price from step one, add it to the value from step two, and then subtract the value from step three. This will give you your value-based price.

Calculate Your Price

Now calculate your price using each of the methods described above.

PRICING METHOD	CALCULATION	PRICE PER UNIT
Cost-Plus	Production Costs + Mark-Up	
Target Return	Production Costs + Targeted Return	
Value-Based	Competitor's Price + Your Strengths – Your Weaknesses	

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Evaluate Your Price

Once you have used any of the strategies described above, you will want to test them out on the market. This can be informal testing by simply asking friends and family a question like, "Would you pay $X for Y Product?" You can also use surveys or focus groups to get feedback on your price. Depending on the information you get from any of these methods or from your own experience, you may find that you will need to make slight adjustments in your price.

For a successful business, your price must also meet **all** of the following criteria:

- In alignment with your market position (i.e. – top quality product vs. discount product).
- Higher than all costs.
- Able to cover variations in sales volume.
- Supports your living expenses.
- Consumers consider it "fair".

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