

Deciding on the “right” price for a product is one of the most challenging tasks for a new business person. If you set the price too low, you may not cover all your costs. If the price is too high, customers may choose your competitors’ products. So how do you decide? The information in this fact sheet will give you some tips on how to determine what you should charge for your product.



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Price and Pricing

Major Pricing Methods

There is a difference between price and pricing. The **price** is the amount of money you want for each product unit. **Pricing** is the process you need to go through to figure out what price to attach to each unit.

Pricing, therefore, is a strategic process that you must learn, and use, for business success. Pricing strategies can be divided into two methods: competition-based pricing and cost-based pricing. Each method has its advantages and disadvantages. Use the following information to help frame your pricing decision.

- **Competition-based pricing** looks at prices charged by the makers of products similar to yours. Ask yourself, “What will the market bear?” Check the retail locations where you think you would like to see your product offered and look at prices for similar products. Then compare your product and the image you want to project with those of competitors’ products. Different perceptions of “premium,” “specialty,” and “store brand” bring to mind unique positions in the market and corresponding price ranges. After this thought process, set your price accordingly.

Advantages of this method: It takes just a little research to come up with a price. Pricing new products lower than competitors’ prices may increase sales.

Disadvantages of this method: All the costs of producing the product may not be covered. A start-up business has costs that established manufacturers covered long ago. Offering a low, introductory price and then raising it later confuses customers.

- **Cost-based pricing** takes all the costs of doing business into account to determine the price of each product unit. Most of your costs should fit into one of two categories: variable costs and fixed costs. **Variable costs** increase in direct proportion to the number of units sold. They include how much you pay for ingredients, labor, packaging, and sales commissions. **Fixed costs** remain fairly constant regardless of how many items you sell. They include building rent, loan payments, insurance, and utilities. Gather all the information about your costs associated with a unit of your product, determine how much profit you will want to make, and then set your price accordingly.

Advantages of this method: Your selling price is backed up by the actual costs of doing business, not just a best guess. This makes it easy to calculate a price that accounts for how much money it costs to do business and what kind of profit you might expect.

Disadvantages of this method: When start-up costs are included in pricing, new products may not compete well with established brands.

Theory into Practice: Price Your Product

In practice, most entrepreneurs use a combination of both pricing methods to set a price for their products. Here’s an example where a blend of the two pricing methods was used to determine a price.

Sam makes Old Virginia Barbeque Sauce using a treasured family recipe. His competition sells similar products for between \$5.00 and \$9.00 a bottle. He decides to price his sauce



at \$8.00. So far, he has used competition-based pricing.

However, as a new food entrepreneur, he wants to cover all his costs but not price himself out of the marketplace. He wants to know how many jars it will take to pay for his fixed and variable expenses and “break even” (cost-based pricing). In the table below, Sam’s expenses are broken down into variable and fixed costs.

The difference between the total variable costs and the unit selling price is called the **contribution margin**. In this example, the contribution margin is \$3.70 per unit (\$8.00 per unit – \$4.30 per unit = \$3.70 per unit). This amount represents how much is “contributed” from each unit of sales toward paying fixed expenses (after taking care of the per-unit, or variable, costs). Sam calculates that, to cover all his fixed costs, he must sell 250 bottles each month (\$925.00/ month ÷ \$3.70/unit = 250 units/month). This is the **break-even point**.

Suppose that Sam wanted to make a monthly profit of \$150 in his first year of sales. He would need to sell a number of bottles beyond breakeven, each contributing \$3.70 toward this goal (\$150.00 per month ÷ \$3.70 per unit = 41 units per month). When this 41 additional bottles is added to the breakeven of 250 units per month, he reaches a total of 291 bottles each month to meet his ultimate goal. If Sam does not believe he can sell 291 bottles a month, he has to adjust one of the variables. For example, he can increase his unit selling price, reduce his fixed and variable costs, or change his monthly profit goal to come up with a more reasonable set of expectations.

Remember, in some ways, pricing is an art combining facts and figures with your best guess. And, as with any art, it takes practice to do it well. Successful retailers carry products that sell, and an inappropriate asking price could earn a “discontinued item” sticker for your product. Invest time into researching and calculating the best price you can determine to start, and retain, a profitable business venture.

For more information, contact your local extension office or visit extension.psu.edu/food-entrepreneurs.

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extension.psu.edu

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Unit selling price: \$8.00 per bottle

Variable Costs	Value per Bottle
Raw materials	\$1.50
Bottle, label, lid	\$0.95
Labor costs	\$1.05
Shipping box share	\$0.80
Total variable costs	\$4.30

Contribution margin: (\$8.00 unit price – \$4.30 in variable costs) = \$3.70

Fixed Costs	Value per Month
Market stand fee	\$75.00
Insurance	\$165.00
Cell data plan	\$100.00
Loan payment	\$300.00
Transportation to market	\$285.00
Total fixed costs	\$925.00

Breakeven: (\$925 in fixed costs ÷ \$3.70 contribution margin) = 250 units (bottles) to break even each month

Speaking from experience

“If you charge bargain hunter prices, you may have plenty of sales, but you will also have trouble paying your bills. I prefer to have customers who know that my product is worth every penny they pay for it.”