Pricing for Profit

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Marketing products includes a wide range of activities such as which product to produce and how to price, place, and promote the product (Churchill and Brown, 2004). Although all marketing activities are important, this publication will focus on pricing.

Pricing products that do not have an established market can be difficult. Produce, like many other types of products, can be priced a variety of ways. Pricing could be as simple as listening or watching customers. One farmer's market producer believes if you don't have a percentage of potential customers walk away from your table, your price is too low (Adam et al, 1999). Other producers won't sell a product if the price is not above their cost of producing and marketing that product. They feel if you can't sell a product for a profit, you shouldn't be growing it.

Making the pricing process more difficult is that each product has multiple customers, competitive markets, and costs. For example, a vegetable grower can sell onions through a community supported agriculture business, farmer's market, institutional outlet like a hospital, care center, or restaurant, or through a wholesaler, among other markets. For each of these marketing outlets there is a range of prices at which the product could be sold and different costs associated with transferring the product to the customer.

Producers often try to maximize their income by selling products direct to consumers through marketing outlets where the highest price can be received (Bachman, 2002). While this strategy may allow producers to achieve the highest gross revenue, it may not yield the highest profit, because of differences in transaction costs.

Pricing

In general, products can be priced based on one of three ways; customers, competition, or costs (Chase, 2006). **Customer** (or market) **based pricing** is focused on how the customer values the product and how customers respond to different price levels. What is he/she willing to pay based on the perceived benefits of the product? There are several variations of customer based pricing. Penetration marketing is where a low price is set to gain initial market share and/or product recognition. Once market share is gained and customer loyalty established, prices may be increased. Price discrimination is often established as a way to vary selling price based on customers' ability or willingness to pay, peak versus off-peak time of year, or other criteria. Loss leaders are products sold at a loss in order to gain other sales of profitable items.

For customer based pricing to work, producers have to be able to sell customers on the value of their product's benefits. Customers have to see a clear advantage to purchasing their products over those of competitors and know how to value the differences. Although customer based pricing methods allow the producer some flexibility in pricing products, costs must be established to verify if the product is actually selling at a profit or loss.

Competition based pricing focuses on what products the competition is offering and at what price. Questions such as: how many competitors are in the market, how much total product is produced, and where are the products grown all need to be understood if pricing is based on the competition. Within competition based pricing there are three primary strategies. First, set prices the same as competitors for similar products. Only if the products are unique or specialized, can prices be set differently. Second, set lower prices than the competition to entice new buyers. This strategy is used to gain potential new customers. Product is likely to sell quickly at lower prices so volume is necessary. The third strategy is to determine a price that will maintain a percentage of the market, or market share. This is a common strategy following an initial lower price to entice new customers.

For **cost-based pricing**, costs need to be determined to ensure that products are being sold for a profit. Budgets need to be developed for each product that contributes substantially to the overall profitability of the business. Budgets need to include all costs of production as well as transaction costs to get the product from the farm or business to the customer. Secondly, a profit margin or percentage should be added to the costs to help cover family living and other overhead expenses.

Remember that cost-based pricing does not take into consideration the customer and what he/she is willing to pay for the product. Competition is ignored as well. A balanced approach may be to use break-even prices as the floor and determine what the customers are willing to pay and the competition will allow as the upper limit to prices. The upper limit can be evaluated to determine what mark-up or margins are available allowing the producers to determine if profit potential meets their pricing goals.

Production and Transaction Costs

An enterprise budget is an estimate of the costs and returns to produce a particular product (Chase, 2006). Enterprise budgets typically focus on costs associated with production through harvest. Enterprise budgets are tools that allow producers to evaluate profitability and determine how changes in production, price, and or product mix can affect future profitability. Production costs do not vary by marketing outlet. For that reason, marketing decisions should be evaluated separately from production decisions.

Transaction costs are those costs associated with the marketing and delivery of the product from the farm to the customer. Transaction costs for farm products would include post-harvest handling, packaging, and storage, as well as the labor to sell, invoice, and deliver the product. Costs associated with coolers or other storage facilities (fixed or portable), as well as transportation units (e.g, vans, trucks, or refrigerated transports) need to be included (Lambert et al, 1998). A separate transaction cost report should be completed as a companion for each enterprise budget. The combination of reports will allow producers to determine profitability for each major enterprise for the farming operation. If multiple marketing outlets are used, a transaction cost report should be completed for each outlet showing the price available, transaction costs associated with, and the return after transaction costs are paid. The reports can be used to choose among outlets.

Transaction Cost Example

For this publication, let's assume we have a vegetable grower in Central Iowa who has the choice of marketing to the Farmer's Market or selling to a small local grocery store or care center. The vegetable farm is small and does not have the volume to sell wholesale through larger outlets. The farm has kept enterprise records for a number of years and has the production system refined and operating efficiently.

Enterprise budgets have been kept for the major crops that provide a majority of revenue and (assumed) profitability. For this publication tomatoes will be used as an example. The production cost for tomatoes can be found in Chase (2006b). The break-even production cost is estimated at $0.38 per pound. The farm produces about 800 lbs of direct market tomatoes. Both a farmers market (twice per week) and a small institutional buyer are located in the closest urban center, which is about 40 miles from the farm.

Marketing research indicates the farmers market is a full retail market whereas the institutional customer pays about 65 percent of retail. On average, approximately 95 percent of what is taken to the farmers market is sold. The other 5 percent is donated. Preparation for, traveling to, operating the booth, tearing-down and traveling back for each farmers market takes 6 hours, twice a week, over the 10-week tomato production season. Pounds of tomatoes taken to market vary by week, but on average 40 pounds of tomatoes are offered for sale per market. The institutional market volume varies weekly because volume of products is agreed upon only two

weeks in advance. However, the institutional buyer would purchase all 800 lbs of tomatoes over the growing season. We will assume the paperwork is the same for both markets, as well as the storage and handling facilities on the farm. The vehicles for the two markets are the same as well. Given this information, which market would be more profitable?

Table 1 shows total estimated cost to produce tomatoes and market them through the farmers' market is $1.96 per pound ($0.38 + $1.58). Total estimated cost to produce tomatoes and market them through the institutional market is $0.83 per pound ($0.38 + $0.45). So which market will return the most profit? That depends upon how the prices for the two markets compare.

Margins and Mark-ups

Break-even prices (production and transaction costs combined) should establish a floor or minimum price. A desired profit goal needs to be added to the floor price to allow for an economic return to management. There are two ways to add a profit goal to a break-even price: price mark-ups and gross margins.

To establish a price mark-up, the desired mark-up percentage is added to the cost of goods. In the case of a person producing their own product, the cost of goods is the same as their break-even price. For example, if a product costs $2 to produce and a 50 percent mark-up is desired, the established price would be set at $3 (150 percent of the $2 break-even cost). In general, wholesalers mark up their products 50 percent, whereas retailers may mark up products 100 percent (Adam et al, 1999).

Gross margin (or gross profit) is the percent of profit desired to be included in the price (Courteau, 2002). To calculate gross margin subtract the desired margin from 100 percent and then divide the cost of goods (or break-even price) by that number. For example, let's assume the desired margin is 35 percent and the break-even price is $2. The sales price to achieve this margin would be $3.08 ($2 / 65% = $3.08). Margins are useful to use and calculate because the natural food store industry, as well as other industries, uses margins to determine profits. The gross margin benchmark for natural food coops is 33-36 percent for the whole store (Courteau, 2002). Because produce has a 3-5 percent shrink due to spoilage and other factors, produce margins for these stores is probably around 30 percent. If a natural food store, for example, wants to sell a tomato for $3 per pound and have a 30 percent margin, it could pay no more than $2.10 per pound for tomatoes ($2.10 / 70% = $3.00).

Table 1. Comparison of transaction costs by market

	Farmers market: 20 weeks/40 markets		Institutional market: 20 weeks	
Transportation vehicle expenses	$.25/mi, 3,200 miles	$ 800	$.25/mi, 1,600 miles	$ 400
Labor charges	2 people @ 12hr/wk, 20wks, @$10/hr	$4,800	1 person @ 4hr/wk, 20wks, @$10/hr (includes selling)	$ 800
Supplies (bags, sacks, other supplies)	$20/wk	$ 400	$30/wk	$ 600
Total transaction costs for the season		$6,000		$1,800
Total transaction costs allocated to tomatoes (20% of total sales)		$1,200		$ 360
Total transaction costs/lb sold	(760 lbs sold)	**$1.58**	(800 lbs sold)	**$ .45**

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Production and transaction costs have been determined for tomatoes and price mark-up or profit margin goals have been illustrated. Because prices in many markets are dictated by competition and customers' willingness to pay, many times pricing for profit becomes a choice of which market outlet should be used. To illustrate this point, let's look at a couple of examples.

Example 1. The expected selling price at the farmer's market is $3.00 per pound on average over the entire season. This price is estimated by the number of different venders selling similar tomatoes as well as the customer's unwillingness to pay more than this amount. The price mark-up goal for taking produce to the farmers' market or the institutional market is 100 percent. The comparable institutional market is a natural food store selling local tomatoes for $3.00 per pound. Their desired gross margin is 30 percent on produce so they are willing to pay no more than $2.10 per pound.

Example 1.	**Farmers' market**	**Institutional market**
Expected selling price	$3.00	$2.10
Production and transaction costs	$1.96	$0.83
Estimated profit	$1.04	$1.27
Estimated price mark-up	53%	153%
Number of pounds sold	760 lb.	800 lb.
Estimated profit	$790	$1,016

In this example, the competitive nature of the farmers' market and customers' unwillingness to pay more than $3.00 per pound over the season for tomatoes does not allow the producer to achieve the price mark-up goal of 100 percent. The institutional market in this example offers the same retail price as the farmers' market and a much higher price mark-up to be received. Overall profitability is higher for the institutional market as well.

Example 2. The expected selling price at the farmer's market is $3.50 per pound on average over the entire season. This price is estimated by the number of different venders selling similar tomatoes as well as the customer's unwillingness to pay more than this amount. The price mark-up goal for taking produce to the farmers' market or the institutional market is 100 percent. The comparable institutional market is an elderly care center with a limited budget. They desire to purchase local products, but figure they cannot pay more than $1.50 per pound.

Example 2.	**Farmers' market**	**Institutional market**
Expected selling price	$3.50	$1.50
Production and transaction costs	$1.96	$0.83
Estimated profit	$1.54	$0.67
Estimated price mark-up	79%	81%
Number of pounds sold	760 lb.	800 lb.
Estimated profit	$1,170	$536

In this example, the competitive nature of the farmers' market and customers' unwillingness to pay more than $3.50 per pound over the season for tomatoes does not allow the producer to achieve the price mark-up goal of 100 percent as well. However, the mark-up received is closer to goal than the previous example. The institutional market offers a much lower price compared to the farmers' market and a comparable price mark-up of approximately 80%. Overall profitability is higher for the farmers' market.

Which market is more profitable is dependent upon the competition, the customer, and costs. Can the producer's product be differentiated from those commonly sold through the same marketing outlet? If the answer is no, then it will be difficult to receive a price different than other suppliers (in this example other farmers' market vendors). Higher prices may be able to be received by moving to a different farmers' market, but whether it would be more profitable would depend on how transaction costs change.

To receive a 100 percent price mark-up for tomatoes in this example would require a price of $3.92 per pound at the farmers' market. Is that a reasonable price based on the competition and/or customers? If it is not and the 100 percent mark-up is still a goal, can costs (transaction or production) be reduced?

In each of the market examples, prices were received above production and transaction costs. This is not always the case. If the competition or customers' willingness to pay does not allow prices to cover these costs then decisions need to be made. If prices cover production costs but not transaction costs, then the product will need to be moved as cheaply as possible to the market allowing for the lowest loss. If prices do not cover the variable component of production costs and production changes cannot be implemented to reduce costs enough, a different product should be produced the following year.

So how is price determined above the minimum price established by the cost based approach? The answer to this question is to look at the other two pricing approaches. Based on conversations with customers, how do they perceive the value of your products? How much are they willing to pay? How many people are walking away from your table or your offer of sale? What is your competition doing and how are you positioning your product? Can you differentiate your product from that of the competition?

The answers to these questions will enable a producer to set a price for a particular product that will take into consideration costs and profit goal, the customer, and the competition.

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