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Smart Pricing Strategies

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Pricing is an important piece of smart marketing. The price a farmer receives depends largely on the distribution channel used to sell the product. Farmers are usually price-takers at terminal and wholesale markets. For farmers, one of the major attractions of direct marketing is the opportunity of gaining control over the prices they can charge. Yet frustration often arises when trying to determine prices, and one of the most difficult problems in direct marketing often centers around the all-too-common practice of price-cutting.

Price provides income, guides the quantity supplied and demanded, serves as a signal to customers, and transfers ownership. Questions one should ask before determining prices include: How much do the competitors charge? How much are customers willing to pay? Does the product have additional value for which the price may be raised? What is the cost to produce the product? And if you slash prices (below competition), how will you maintain profitability?

The most basic element of pricing is to know your costs, including variable costs and fixed costs. Variable costs are cost items directly related to production -- plants, seeds, fertilizer, labor, packaging, etc. Fixed costs are cost items that do not vary with production volume, such as rent, taxes, management salaries, and cost of capital. The price of one item should at least cover variable costs in the short run and need to cover both variable and fixed costs in the long run. It is important to establish a gross margin that will cover the total costs of growing and

marketing the product and provide a satisfactory profit for the business. Gross margin is the difference between the cost of the product and its selling price.

$$\text{Gross Margin \%} = \frac{\text{Selling Price} - \text{Cost}}{\text{Selling Price}} * 100$$

$$\text{Retail Price (\$)} = \frac{\text{Cost of Goods Sold (\$)}}{100(\%) - \text{Desired Gross Margin (\%)}} * 100$$

After the prices are established based on the desired gross margin for each product, it is often necessary for the smart marketer to adjust the prices to match the marketing strategy. One might want to lower prices of certain items to meet competition, attract customers to the retail outlet (i.e., advertised specials), or sell products that may have been damaged, overstocked or seasonal. Sometimes one will want to increase prices of certain items to reflect the value of a unique product, a special service, or a prestige image. When considering changing prices, it is important to calculate the impact of such a reduction or increase on the total gross margin of the business. This can be done as illustrated in the following example.

Assume a direct marketer is selling just five major items from a farm stand. The direct marketer has calculated the gross margin for each product sold using the cost of goods (a cost of production or market wholesale price) and has also estimated the approximate sales for each product as a percentage of total sales. The percentage of sales and gross margin for each product are shown below.

Contribution to Total Sales and Gross Margin before Price Reduction

| <i>Item</i> | <i>A. Percent of Total Sales (Estimated)</i> | <i>B. Percent Contribution to Gross Margin</i> | <i>C. Total Gross Margin (C = A x B)</i> |
|--------------|--|--|--|
| Apples | 35 | 30 | 10.5 |
| Mums | 10 | 35 | 3.5 |
| Pumpkins | 15 | 30 | 4.5 |
| Sweet Corn | 10 | 20 | 2.0 |
| All Others | 30 | 20 | 6.0 |
| Total | 100% | | 26.5% |

In this situation, if the direct marketer lowered the price on pumpkins as a Halloween promotion to meet a lower price by a competitor or to sell out the seasonal stock, the price reduction resulted in a gross margin of 10 percent (a drop from 30 percent) and stimulated sales

to increase to 20 percent of the total (up from 15 percent). The impact of the price reduction on the total sales and profits of the business could be calculated as follows:

Contribution to Total Sales and Gross Margin after Price Reduction

| <i>Item</i> | <i>A. Percent of Total Sales (Estimated)</i> | <i>B. Percent Contribution to Gross Margin</i> | <i>C. Total Gross Margin (C = A x B)</i> |
|--------------|--|--|--|
| Apples | 33 | 30 | 9.90 |
| Mums | 9 | 35 | 3.15 |
| Pumpkins | 20 | 10 | 2.00 |
| Sweet Corn | 10 | 20 | 2.00 |
| All Others | 28 | 20 | 5.60 |
| Total | 100% | | 22.65% |

Therefore, the direct marketer could forecast a drop in total gross margin from 26.50% to 22.65%, or a loss of -3.85% in gross margin. Assuming that sales for the business averaged \$5,000 per week, this would mean a loss of: $\$ 5,000 \times -3.85\% = -\192.50 .

However, if the lower price on pumpkins attracted more customers or more sales for the business, and resulted in an overall increase in sales of more than \$192.50, the result would be an increase in total gross revenue for the direct marketer.

For example:

Gross margin before the price reduction $\$5,000 \times 0.265 = \$1,325.00$

Gross margin after the price reduction (with a \$900 sales increase) $\$5,900 \times 0.2265 = 1,336.35$

Now there is a slight gain in total gross margin.

Remember that having the “lowest price in the market” image can’t get you higher prices for higher quality products. Having a “value” image is to reach an optimal combination of quality, service, information and price. Price competition in a market situation with multiple similar sellers in one location can cause severe consequences.

The following are some pricing strategies for *Smart Marketers*.

- Price-lining: Price-lining features products at a limited number of prices, reflecting varying product quality or product lines. This strategy can help smart marketers sell top quality produce at a premium price and an “economy line”, e.g., overripe or smaller

fruits. Price-lining can also make shopping easier for consumers and sellers because there are fewer prices to consider and handle.

- Single-pricing: The single-price strategy charges customers the same price for all items. Items are packaged in different volumes based on the single price for which they would be sold. With such a policy the variety of offerings is often limited. The strength is being able to avoid employee error and facilitate the speed of transactions. Also, customers know what to expect. There are no surprises for customers.
- Loss-leader pricing: A less-than-normal markup or margin on an item is taken to increase customer traffic. The loss-leaders should be well-known, frequently purchased items. The idea is that customers will come to buy the “leaders” and will also purchase regularly priced items. If customers only buy the “loss leaders,” the marketer is in trouble.
- Odd-ending pricing: Odd-ending prices are set just below the dollar figure, such as \$1.99 a pound instead of \$2.00. Some believe that consumers perceive odd-ending prices to be substantially lower than prices with even-ending. However, it might not be suitable in some markets. For example, in a farmers’ market situation, products should be priced in round figures to speed up sales and eliminate problem with change.
- Quantity discount pricing: A quantity discount is given to encourage customers to buy in larger amounts, such as \$2.00 each and three for \$5.00. Gross margins should be computed on the quantity prices.
- Volume pricing: Volume pricing uses the consumer's perception to the business's advantage, and no real discount is given to customers. Rather than selling a single item for \$2.50, two are priced for \$4.99 or \$5.00.
- Cumulative pricing: Price discount is given based on the total volume purchased over a period of time. The discount usually increases as the quantity purchased increases. This type of pricing has a promotional impact because it rewards a customer for being a loyal buyer.
- Trade discount/Promotional allowances: Price is reduced in exchange for marketing services performed by buyers or to compensate buyers for performing promotional services.

- Cash discount: A discount is given to buyers who pay their bills within a specified period of time to encourage prompt payment.
- Seasonal discount: This type of discount is used to induce buyers to purchase at the end of the season or during off-season.

While the above strategies are widely used and have been proven effective, smart marketers should not be limited to these strategies. Creative pricing ideas can help you differentiate your products and services. No matter how you price your products, always go back to check it against your bottom-line. Make sure prices for your products reflect your business image and target market and make a profit. Smart pricing can be a good marketing strategy.

Smart Marketing is a monthly marketing newsletter for extension publication in local newsletters and for use by local media. It reviews the elements critical to successful marketing in the food and agricultural industry. Articles are written by faculty members in the Department of Applied Economics and Management at Cornell University.

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