



START UP SMARTS ACADEMY

BUILD A BUSINESS YOU LOVE

Power Pricing: Demystifying Profit Margins and Mark-ups

Many of the inventors and entrepreneurs we meet got started because they wanted an outlet for their creativity or sought freedom in their careers. Less commonly people approach it from a number-crunching background...which means that many entrepreneurs are not as comfortable with “the numbers.” However, if you create a viable product, you’ve got to sell it, and pricing and profit margins are a part of it.

Whether you sell directly to end-users, or to a retailer or distributor who sells it to customers, you need to know how to price your product to ensure everyone in the process will make their required profits. As you probably suspect, this involves a bit of art – *and* a bit of science!

Common sense dictates that you price your product at an ideal number – one that is neither too high nor too low - and will attract the most customers and generate the greatest amount of profit. You also need to establish a price that covers the cost of doing business. This is where understanding the basics of “markup” and “gross margin” can help.

Before we get into each of these, a few terms need to be defined:

Retail sales:

Sales of a product to an end user. Example: buying cookies at a grocery store.

Wholesale sales:

Sales by a manufacturer or distributor to a retailer (who, in turn, sells it to the end users through their retail store cited above). Example: Nabisco sells its cookies wholesale to grocery stores.

Markup:

The difference (reflected in both dollars and percentage) between what a retailer will pay for a product and its retail price (what the end user will pay.)

Example: XYZ Cookie Company sells a bag of cookies to the grocery store for \$2, and the grocery store charges \$5. The markup is \$3 per bag.

Gross Margin: Percentage of profit derived from the transaction. (Both the manufacturer and the retailer will expect to earn their own gross margin.)

How Markup Works:

The best way to illustrate the concept of markups is with a simple example.

Assume you, the manufacturer, make a product we'll call Gizmo for \$1. You then sell it wholesale (to a retail store) for \$3. Thus, your markup is \$2. ($\$3 - \$1 = \2), or 200% (2 divided by 1 = 2.00 **remember, percentages are reflected by moving the decimal point two spaces to the right and adding the % symbol, hence 2.00=200%). If the retail store, in turn, sells Gizmo for \$8, its markup is \$5 ($\$8 - \$3 = \$5$), or 166% (5 divided by 3 = 1.66).

Figuring Out Your Gross Margin:

Now that you know your markup, you can figure out gross margin. (Note: these two terms are OFTEN mistakenly used as though they are synonyms. They are related but NOT the same.) This number is calculated by dividing the markup by the price to acquire it. Using the same example, we'll first figure out your gross margin as the manufacturer. Divide your markup (\$2) by the price the retailer paid you for it (\$3). Thus, your gross margin as the manufacturer is

67% (2 divided by 3 = .67, or 67%). So in this case a 200% markup resulted in a gross margin of 67%.

You should also figure out your retailer's gross margin. (I'll explain why this is important in the next section.) Calculate it the same way, only using the retailer's markup (\$5) and price (\$8). So: \$5 divided by \$8 = .625, or 62.5%. Thus, the retailer's 166% markup resulted in a 62.5% gross margin.

Retailer Markup and Gross Margin:

So, why is it important to know your retailer's gross margin? This will also help determine your own price. That's because retailers often have minimum margin requirements. Although these will vary widely, depending on the type of retailer (specialty/catalog/online retailers versus mass-market retailers, for instance), it's not uncommon for a retailer to expect a minimum gross margin of 50%. This is often referred to as a "keystone" markup.

An easy way to figure out this number is to double your wholesale price. For example, if you sell your product wholesale to the retailer for \$5, the retailer will need to charge the consumer \$10 to achieve a "keystone" markup. When you need to work backwards to figure out a price that gives your retailer the desired margin, it's helpful to use the 50% "keystone" expectation as a starting point. Note that high-end specialty retailers will often require an even higher gross margin. So don't be shy about asking your retailers their margin requirements – this is how retailers think. Most of the more experienced buyers we dealt with confidently offer either a specific number or at least a pretty narrow range.

Now that this is clear—or at least a bit less murky – I'll throw in a new wrinkle: Distributors.

Distributor Gross Margin:

Distributors are companies that typically buy products (and store inventory) from manufacturers and sell them to retailers. They are commonly used by larger retailers that handle a large volume of products, such as grocery stores.

Distributor margin requirements vary by product price point, industry, segment, country, and size, but they are typically lower than retailers – 20% to 40% is not uncommon. That's because, as the middleman, there are two markups required – the distributors and the retailer to which he sells.

For example, the margins and markups for a product sold through a distributor might look something like this (assume a 50% gross margin requirement for the retailer and a 30% gross margin requirement for the distributor):

Gross Margin = GM

\$10 retail price - sold by retailer to consumer (Retailer GM = 50%)

\$5 wholesale price - sold by distributor to retailer (Distributor GM = 30%)

\$3.50 distribution price - sold by manufacturer to distributor (Manufacturer GM = 43%)

\$2 - manufacturer's cost to produce product

How Much Is Enough?

There is no one “magic” gross margin to strive for – they vary dramatically by industry and product type. Even within a single industry, they fluctuate. A large mass oriented manufacturer may be satisfied with 20% to 30% or less. At a massive sales volume, they can be profitable at this rate! However, many small businesspeople I know strive for a 50-70% gross margin. Here are some strategies to figure out where yours should fall.

On the high end, your gross margin should be “as much as you can get!” The factors influencing this are your own production costs, your retailer’s margin expectations, and the market price at which your product will sell (this is the most important.) So, if your production cost is so low and your product is in such demand that you can sell enough of them for a 1,000% gross margin (until competition enters the space), go for it!

What about the low end? When is your gross margin too low to sustain the cost of doing business? The answer lies in your goals and your expenses. Remember that all of your company costs, including salaries, rent, marketing and other operating costs must be covered by the gross margin earned on your sales. There is a term for this, too – your “net profit margin”, or the percentage of money left after paying for all these expenses plus production costs. So what’s a decent net profit margin?

Sometimes it is necessary to compare the opportunity this investment represents with other ways money and time can be invested. “Opportunity cost” is how this is sometimes characterized.

Let’s use the following as an example: Assume you can make around an 8 to 10% return in the stock and bond market, without much risk or effort. You may conclude that you need to outperform this return on any output of capital (investment in your business). In other words, if you can make 8% relatively easily in stocks, you’ll definitely want to make a higher net margin on a business venture in which you’re putting so much more time, effort, and risk.

Back to gross margin. You’ll know it’s too low if you find you’re unable to meet the costs you regularly incur to operate your business. In this case, you have two options – find a way to lower your production and operating costs, or raise

your price. A final factor to keep in mind: your gross margin may grow over time. In the early stages, manufacturing runs are often smaller (thus more expensive per unit). Plus, you need to create demand for your product, so you don't want to set your price too high. Therefore, you may need to forgo large profits, or any profits, in the beginning to get a sense of your market and create sales traction. Then, once your demand begins to grow, your production costs will decrease. Unfortunately, this can work in the opposite way, as well, once major competition enters your space. That is why it is typically expected that your margins are highest in the early stage of a product launch.

GET STARTED:

For help in figuring out your own numbers, we offer a margin calculation tool. This calculator can help you determine the optimal selling price for your product. By entering the wholesale price, and either the markup or gross margin percentage, you can calculate the required selling price and gross margin.

Good luck! If you're not a numbers person, be kind and patient with yourself. Everything is right here for you to reference as many times as you need to. And, the Margin Calculator that you get as a bonus with our guidebook, [How Hot is Your Product?](#) is something you can play with again and again until it's just right for you. Also, don't forget to ask for help when you need it.