Brooding on Matters | Travis Todd

Not sure what this is going to turn into…

Pricing, Markup, Margins and Mass Confusion

Posted on 17 September 2009

I was recently talking to some local business owners about what it would take to put a product on their shelf, a product that I've developed and would like to take to market. After talking to a couple businesses, working in the exact same industry, it became apparent to me that when I asked what their typical retail margins were for a product such as mine, we weren't always speaking the same language. I was given a few answers that were close to being in-line, and then I got a couple fliers. So I dug deeper to determine how they calculated their "margin", and found that "markup" and "margin" were being used interchangeably.

Why does it matter, well product pricing is a very important aspect of entrepreneurship and running a business, and probably a subject that a lot of people don't fully understand?

That said, the concepts are actually quite simple.

- Markup is based on the cost one purchases a product for
- Margin is based on the sales price one sells the product for

The following equations are used in the examples below:

Margin (%) = (The price you sell at – The cost you buy at) / The price you sell at

The price you sell at = The cost you buy at / (100% – Margin (%))

Markup = (The price you sell at – The cost you buy at)

Markup (%) = (The price you sell at – The cost you buy at) / The cost you buy at

Markup = The cost you buy at * Markup (%)

The price you sell at = The cost you buy at + Markup

The price you sell at = (The cost you buy at * Markup (%)) + The cost you buy at

It is probably easiest to use two examples to show the concept.

Example 1.

The first is the case where you develop a new widget and want to sell it at all of the local hardware stores in the country. Let's assume that you are able to manufacture the item, and you will sell the widgets to a wholesaler, whom will take care of distributing your product to all the retailers across the country.

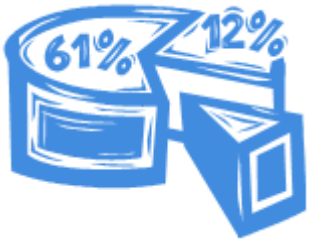
Your Pricing

Your cost to manufacture and package your widget is $10/unit. You want this to make you rich over night, so you decide that you will sell the product to your wholesaler for $19/unit. You have marked-up the product $9, which will cover your operating expenses and provide for a nice profit.

Your Cost = $10

Your Markup = $9

Price You Get = Wholesale Cost = Your Cost + Your Markup = $10 + $9 = $19



Markups and Margins

We can now calculate what your percentage markup and margin are:

Markup (%) = Your Markup / Your Cost = $9 / $10 = 90%

Margin (%) = Your Markup / Price You Get = $9 / $ 19 = 47.4%

We are already starting to see a markedly different set of values for terms that are sometimes used interchangeably. If I were to ask you what your margin is and you replied 90%, that would be drastically different than the actual 47.4%.

Wholesale Pricing

Let's continue, when you work out a deal with your distributor they tell you that they require a 25% margin to move your product.

Wholesale Cost = $19

Wholesale Margin (%) = 25%

Price Wholesale Gets = Retail Cost = Wholesale Cost / (100% – Wholesale Margin (%)) = $19 / (100% – 25%) = $25.33

From this we can now calculate the actual and percentage markup.

Wholesale Markup = Price Wholesale Gets – Wholesale Cost = $25.33 – $ 19 = $6.33

Wholesale Markup (%) = Wholesale Markup / Wholesale Cost = $6.33 / $19 = 33.3%

Retail Pricing

And finally the wholesaler is able to sell the product to the retailer. In this industry we'll assume that it is standard that products of this type are marked-up 50%.

Retail Cost = $25.33

Retail Markup (%) = 50%

Retail Markup = Retail Cost * Retail Markup (%) = $25.33 * 50% = $12.67

Retail Price = Retail Cost + Retail Markup = $25.33 + $12.67 = $38

So we can now determine the Retail Margin.

Retail Margin (%) = Retail Markup / Retail Price = $12.67 / $38 = 33.3%

In summary, the product that you developed for $10, after your markup, wholesale markup and retail markup is now selling at hardware stores for $38.

Example 2.

Now, lets work backwards. You have developed your new widget and you know that your competitions product retails for $23 in hardware stores. You know yours is slightly better, but will not be able to sell for $38. You are pretty sure that your product will sell for $27.



Squeezing Margins

We'll assume that (the same as in example 1):

Retail Margin (%) = 33.3%

Wholesale Margin (%) = 25%

Retail Pricing

So, if the suggested retail price of the item is $27, then:

Retail Markup = Retail Price * Retail Margin (%) = $27 * 33.3% = $9

Retail Cost = Wholesale Price = Retail Price – Retail Markup = $27 – $9 = $18

Wholesale Pricing

Now to determine the wholesale markup and cost:

Wholesale Price = $18

Wholesale Markup = Wholesale Price * Wholesale Margin (%) = $18 * 25% = $4.50

Wholesale Cost = Your Price = Wholesale Price – Wholesale markup = $18 – $4.50 = 13.50

Your Pricing

In this scenario, it costs you $10 to produce your widget and you are only able to sell it to wholesale for $13.50.

Your Margin (%) = Your Markup / Your Price = $3.50 / $13.50 = 25.9%

This is substantially less than the 47.4% margin that you received in the first example, but you can see how it allows you to make a business decision. If the product must sell for $27, it costs you $10 to produce, then you have to decide if a 25.9% margin per widget is acceptable to pursue the opportunity, remember that the 25.9% must cover your operating expenses, marketing, with something left over in the form of profit.

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Tags: Entrepreneur, Margin, Markup, Pricing

7 responses to *Pricing, Markup, Margins and Mass Confusion*

- *The Incentive Behind Pricing | General Thoughts | TravisT* says:
September 17, 2009 at 12:08 pm

[…] recently wrote an article about pricing, markups, and margins and thought I could go a little further in depth on the importance of the topic – in a little […]

Reply

- *Roy Gamlin* says:
October 1, 2009 at 9:52 am

Thanks for such a useful post, and the followup one too. Working back from the achievable retail price, and, allocating the various measured percentages between the parties, is the process I have worked through on the back of an envelope recently. Like you say, the decision has to be made on whether the margin is enough to make the enterprise 'a runner'. Its what makes entrepreneurship exciting. Best wishes, RG (UK)

Reply

- *Travis Todd* says:
October 1, 2009 at 12:11 pm

  Roy,
  Thanks for the kind feedback. Good luck with the product!

  Reply

  - *Roy Gamlin* says:
  October 1, 2009 at 3:23 pm