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Dear :



## Profits & Profit Margins

Business textbooks often talk about "the margin." They measure this as either a single price (or unit), or as a percentage. The margin is the difference between your cost, and the price at which you sell the item.

And so, we've come to the very basis of everything that we talk about from here on out: cost. You cannot accurately do anything until you know the cost of something.

"Cost" is something more than "price." Price is the amount of money you take out of your pocket to pay for a product or service. Cost is everything you give up in order to make something yours. That includes money, but it also includes things like time, space, and convenience - the value of which we usually express in money.

Let's say you make small wooden pen holders to keep on desks. You find a dead oak tree at the side of a road, so you have no cost in walking into the woods, cutting the tree down, and hauling it back to your workplace. However, a lot of that tree will be turned into sawdust which can't be sold as it is. You paid for the tools you work with to make your job faster and easier. In order to make these pen holders, you've given up the opportunity to get paid by someone else to dig a ditch, or put canned peas on a shelf, or to do any number of things that would

put cash in your pocket. Let's say when you're done cutting, sanding, and sealing the wood you've got 100 pen holders.

You decide to value your time and the use of your tools at a certain hourly rate, and that value just happens to come out to \$100. \$100 divided by 100 pen holders comes out to a cost of \$1 per pen holder.

Now that you've established that, you can begin figuring out a way to price the holders that pays for each of them, plus gives you money to pay your expenses, and also pay yourself a wage for the work you've already done, and will do in the future. You decide to set a price of \$5 each for the pen holders.

If the cost of each holder is \$1, and each holder sells to an end user for \$5, then the unit margin is \$4.  $\text{Price} - \text{Cost} = \text{Margin}$ .

If you want to know the margin percentage, its Unit Margin divided by Unit Selling Price. In this case, that's  $\$4/\$5 = 0.8$ , or 80%.

Almost all the business people I've talked with refer to this as **profit**, or the extra money you get over the cost of doing business - although there's a lot more that goes into "cost" than simply what you pay to acquire a unit of something. Some large businesses refer to this internally as "margin." Most small businesses I've dealt with refer only to the percentage as "profit margin."

## Pricing

### Cost plus

How did we come up with the price of \$5 for the pen holders above? Frankly, we just made it up. There are many ways to set the price of an item once we know the cost.

I once worked for a computer reseller, back in the days when a \$3,000 desktop could almost balance your checkbook. The owner's pricing formula was  $\text{Base Cost} \times 1.45$ . So if the equipment cost us \$2,500 to bring in, by the time we built it and installed all the software, the end user paid us \$3,625 plus tax.

Some businesses use an even simpler formula. They simply add a set dollar amount to the cost of an item or service, and charge their customer that amount. A plumbing service might pay a tech \$65 per hour to service a business or residence. The service decides that their price for a visit is \$115 per hour, which they get by adding \$50 on top of the technician pay rate. So if they sent an apprentice out, they might instead charge \$75 per hour, which would be \$50 on top of the \$25 per hour they pay the apprentice.

### Commodity

A commodity is an item which is difficult, or even impossible, to distinguish from an item sold by someone else. In cases like that, we often say that the prices

"race for the bottom." That is, competitors keep lowering their prices in order to gain business from buyers who can't distinguish between the products by anything other than price. All things being equal, they want the lowest price for an equal product or service.

There are many products that are seen as a commodity, like wheat flour, or cement, or water, or even sandals.

If you're going to sell what others see as a commodity at a higher price, you have to find some way to differentiate your version from "all the others." Maybe it's a color, a size, or even just a brand name. Otherwise, you're in a race with your competitors to see who can go out of business first.

### **Premium**

A premium price is built not from components cost. Rather it is based on the value of what solutions the final product offers. Most wheat flour is offered at commodity pricing, but some is offered at a premium. Most if not all of those premium priced flours are branded (King Arthur, Gold Medal, etc.), and the increased revenue provided by the premium price is used to either build in an actual benefit ("fine grind - doesn't need sifting" or "now with baking soda" and so on), or merely imply one ("when only the best will do").

An example from a capstone marketing class I took talked about iron coil pads that replaced hundreds of asbestos pads in the process of driving piling with giant drophammers. The cost of the asbestos pads - which needed to be added to by hand every 15 minutes or so - was about \$100. The cost of the wound steel pad, which would last nearly all day, was about \$75. How much should the selling company price the steel pads? The final price took in the cost of the downtime for replacing the asbestos sheets, as well as the fact that a driver could finish a piling in less time. The premium price was about 2.5X the price of the asbestos pads.

A premium price sells the benefits, and not the features alone.

Thanks for subscribing. I think these metrics are extremely important for your business.

Until next time, be well and stay healthy & happy.

Very best,

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