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# Is there a place for 'marginal' business?

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*This paper is one of a series that expands some of the ideas, questions and techniques that arise in the author's delivery of the MJC Sales Strategy Service. The purpose is to inform and to stimulate interest, comment and debate.*

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## **Is there a place for 'marginal' business?**

The short answer is yes, but with a huge caveat ! The implications must be thoroughly understood and the dynamics very carefully managed, because marginal business is like Pandora's box: once opened, the effects are irreversible.

Organisations that already do it, and especially those that depend on it to keep the ship afloat, know the issues only too well, and have a particular challenge in framing a robust sales strategy.

So what exactly is 'marginal' or 'incremental' business?

Ideally, every product delivers the minimum target margin, and the plant operates at its capacity. Unfortunately, markets and customers are not often that co-operative, and the plant either has spare capacity, or it produces some products that are below the target margin, or both.

The issue of marginal business arises when there is significant fixed cost in the business. Fixed cost by definition is independent of the volume of sales. Higher sales means the fixed cost is spread more widely, reducing the fixed cost per unit and increasing the profit. When the plant has spare capacity, it can be very tempting to accept business that does not deliver the required margin, or may not even cover full cost, on the grounds that it is contributing to fixed cost and therefore makes every other product more profitable. The example below illustrates the point.

An organisation aims to sell 1,000 units at £70 per unit. Its variable costs (raw materials, energy) are £20 per unit, and its fixed costs (labour, depreciation, rent, selling costs and administration) are £30,000. If it does not sell a thing, there will be no variable cost – no materials or energy will be used - but the fixed costs remain unchanged.

Under the budget, its profit will be £20,000, or £20 per unit. (scenario 1)

If it fails to sell 1000 units, its profit will drop, the break-even point occurring at 600 units (scenario 2). Equally, if it can increase its sales to say 1200 units at £70 per unit, the profit will rise steeply, to £30,000, or £25 per unit. (scenario 3).

Let us suppose that the 1000 unit level will be difficult to increase, but an extra 500 units could be sold into a different market at a much lower price, say £40 per unit. The fixed cost is no longer £30 per unit but £20 per unit – the original £30,000 spread over 1500 units instead of 1000. In fact, the net effect is to increase profits to £30,000, maintaining the average of £20 per unit. (scenario 4)

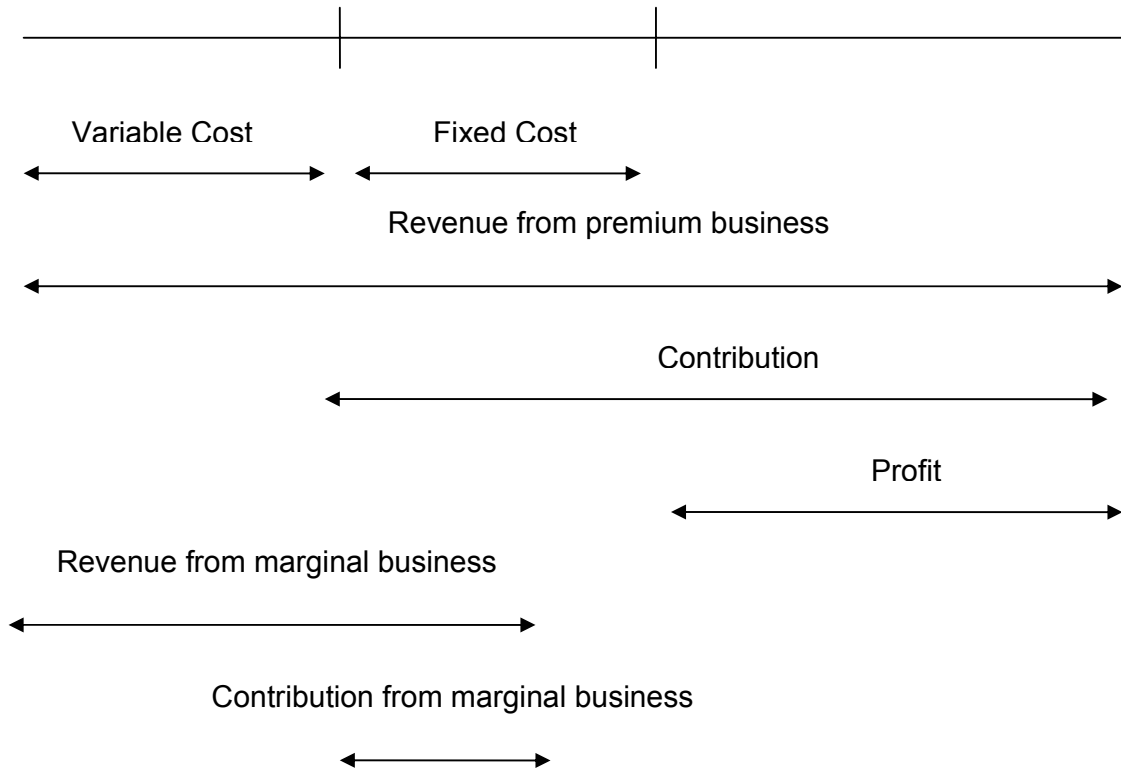
If the high-price sales fail to materialise, the argument is even more compelling. If they can only sell 500 at £70, which would generate a loss of £5,000, selling another 500 at £40 would appear to be a veritable lifeline, as it would then generate a net profit of £5,000 (scenario 5 and 6)

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Scenario	Costs and Revenues in total						Costs and Revenues per unit					
	1	2	3	4	5	6	1	2	3	4	5	6
Units sold at £70/unit	1000	600	1200	1000	500	500	1000	600	1200	1000	500	500
Units sold at £40/unit	-	-	-	500	-	500	-	-	-	500	-	500
Variable at £20/unit	20,000	12,000	24,000	30,000	10,000	20,000	20	20	20	20	20	20
Fixed Cost	30,000	30,000	30,000	30,000	30,000	30,000	30	50	25	20	60	30
Full Cost	50,000	42,000	54,000	60,000	40,000	50,000	50	70	45	40	80	50
Revenue	70,000	42,000	84,000	90,000	35,000	55,000	70	70	70	60	70	55
Profit	20,000	-	30,000	30,000	(5,000)	5,000	20	-	25	20	(10)	5

The concept of 'contribution'

When an organisation is working with marginal business, the benefit can be easier to comprehend and manage by using the concept of 'contribution'. By taking the total revenue and deducting the variable costs, the organisation is left with the sum that has to pay the rent and the other fixed costs, the remainder being the profit. Whether a product is sold above or below full cost, it is said to be 'contributing' to the fixed cost, hence the term 'contribution'. When there is an array of products with different 'contributions', it is easy to see which are the biggest 'contributors', and the sum of the contributions quickly reveals if and by how much they exceed the total full cost. (i.e. if the total generates profit).



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Here is the same data as above but organised according to contribution:

Scenario		1	2	3	4	5	6
Units sold at £70/unit		1000	600	1200	1000	500	500
Contribution	50/unit	50,000	30,000	60,000	50,000	25,000	25,000
Units sold at £40/unit		-	-	-	500	-	500
Contribution	20/unit	-	-	-	10,000	-	10,000
Total Contribution		50,000	30,000	60,000	60,000	25,000	35,000
Fixed Cost		30,000	30,000	30,000	30,000	30,000	30,000
Profit		20,000	-	30,000	30,000	(5,000)	5,000

So what's the catch?

The problem is not with the theory – which cannot be denied – but with what tends to happen in practice. For a variety of reasons, once an organisation starts to accept marginal business, it can become very difficult to manage while maintaining the premium business at it was.

### 1. Market Reaction

Marginal business is someone else's premium business, and they are unlikely to accept a newcomer lightly. They will try to protect their business, and if they have the capability, counter-attack at the organisation's premium accounts. Unless the position at the premium accounts is very strong, the result is likely to be depressed prices – across the board!

### 2. Different values and drivers

By definition, a marginal business will value less highly the organisation's strengths. This may make the initial sale harder, or it may make keeping the business harder. Either way, the sales effort is now split between premium and marginal, diluting the organisation's attention to the more important business.

### 3. Keeping premium and marginal business separate

This is critical, both in the minds of the sales force and in the minds of the target customers.

The sales force are now dealing with two types of business simultaneously, and are trying to apply different rules (sales arguments) to each. When the pressure is on, they will tend to revert to the ones they know, and in this case that means the risk of extending premium services to marginal customers.

It is equally important to ensure that premium customers do not perceive that others are getting the same products at lower prices. If, for example, the argument rests on the value of a service, it is vital that the service is truly valued by the premium customers, and it is clearly not being offered to the lower-price customers.

There is always a tendency for differentiated markets to merge (at the lower level!), and the effort to keep them separate can consume huge amounts of sales and marketing

effort, as is very evident in, for example, the motor and airline industries.

4. Fixed costs assumed to be uniform across whole range

The calculation above is very simple and explains the logic very clearly. However, it reinforces the tendency to average fixed costs, revenues and profits over the entire range, and lead people to the wrong conclusions. It is easy to distinguish the lower contributors, but much harder to isolate those that consume extra fixed cost. Large volumes of low unit-contributing product (i.e. those that make a large contribution by virtue of their volume) have a particular appetite for fixed costs!

5. Fixed costs rising to accommodate higher volumes and more complex administration

After a while, extra volumes and extra complexity demand extra people to administer them and perhaps extra plant or warehouse space. Suddenly the fixed costs become 'fixed' at a higher level, and some of the benefits are lost. If revenues are under pressure as well, the equation is squeezed from both sides.

6. Capacity reached

When the plant is only half full, it can seem a very distant dream to fill it. The pressure is on to fill it as quickly as possible, and it can be very difficult to know when to take the foot off the accelerator. If there is no monitoring system in place, it may not even be obvious until deliveries start being delayed and customers from all parts of the spectrum start screaming. There may even be pressure to expand the plant to cope with the extra demand.

Some industries have reacted to the problem by developing very sophisticated systems to manage marginal business, but it has come at a very high price. It is little wonder that many managements whose business is already profitable refuse to entertain any marginal business, and insist that the organisation puts all its effort into finding and retaining only profitable business, in other words to concentrate on the markets, products and customers where it is truly profitable and either has or plans to have a significant position.

Meanwhile, those that do not have that luxury may have little choice: they must fight to keep even their marginal business unless and until they can find better business to replace it, otherwise their fixed costs are going to sink them. Drastic surgery, such as losing people, may then be the only answer.

Some of the rewards and pitfalls of working with marginal business are illustrated in the following case study :

## **Case Study**

*The following case study is based on a real situation, and illustrates the rationale of a marginal business strategy, and the benefits and the problems associated with it. In this case it was not necessarily the wrong thing to do; but its dynamics were not thought through and managed closely over several years to ensure a clear distinction in everyone's mind between premium and marginal business, and to respond to changing conditions.*

*This study uses market definitions derived from the Boston Consulting Group's market matrix model, as follows:*

- A1 : Company has strong position in a growing market (BCG : 'Star')*
- A2 : Company has strong position in a static/declining market (BCG : 'Cash Cow')*
- B : Company has weak position in a growing market (BCG : 'Problem Child')*
- C : Company has weak position in a static/declining market (BCG : 'Dog')*

ABC Ltd supplied a refined mineral to four market segments, which they defined by the product lines they supplied to them, called Products P, Q, R, and X.

At a certain time, they sold only P, Q and R into markets that were either A2 or just A1 (static, or growing slowly), sustained by superior quality and extensive technical support to customers. The plant ran at about 60% capacity, including its rejects and losses, and struggled to break even. The most promising growth market was unfortunately the smallest, and was going to need much effort and some plant investment to make it happen. There were no really significant B markets that ABC could target to convert into an A1 of the future, which left a clutch of large, static and rather unattractive C markets.

Unfortunately, price was the primary driver in these B and C markets, and market prices were below ABC's full cost. Quality had to be consistent but otherwise was nothing special; customers welcomed technical support but did not really need it, and certainly would not pay for it.

Deciding that growth in the A1 markets was not going to fill the plant and could not be funded by the current profitability, the Management calculated that if they could fill the plant with extra products at prices below full cost, they could generate enough contribution to absorb much of the plant's fixed costs, and thereby generate a healthy profit.

They therefore took the strategic decision to go for a slice of the large volumes available in some B and C markets, and unleashed the sales force with the instruction to increase sales of Product Line X wherever they could at whatever price was necessary above variable cost. The plant meanwhile was charged to improve its productivity and reduce its rejects and losses (primarily to improve the quality of the premium products), which had the additional effect of increasing the capacity.

Five years after the strategy was implemented, the capacity had increased from 55 to 78,000 tonnes through improvements in manufacturing technique and some investment. The sales volume doubled, from 39 to 76,000 tonnes, revenue climbed by 60% to 25 m,

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and the profit soared, from 0.5 to 4 m, generating an ROC of 10%. ABC had filled the plant, which now operated continuously with the added benefits of consistent quality and much reduced rejects and losses. They had maintained their share of their key A2 markets, had the majority of the A1 market, which had doubled in size in part thanks to effective and well-targeted technical marketing, and established a sizeable position in the B and C market sector. The ROC target of 12% looked achievable.

It was not to be. Two years after that, the tonnage was slightly higher, at 77,000 t, but the revenue declined to 23 m, and the profit collapsed to 0.3 m. On top of that, the product mix had changed and created a capacity crisis, which affected all customers.

A closer look at the key product lines showed that all four suffered a loss of revenue per unit, and in fact had done so even at the five year mark. The negative dynamics that had been set in motion by the original strategy had caught up with and overtaken the benefits, largely because they were imperfectly understood by management and were not properly controlled. Meanwhile, fixed costs spiralled both in the plant and in the field.

So how did the dynamics change?

- ❖ As soon as ABC entered the X market, competitors reacted by moving to protect the business ABC was targeting, and to counter-attack ABC's premium business. The net effect was to drive prices down across all products.
- ❖ part of the selling argument was ABC's superior reputation, which had been built up over the years on technical service, quality, and reliability. The customer-orientation that ABC had developed as part of its sales culture, and which was justified by the premium quality and pricing of its products, could not help but envelop the marginal business too. Customer expectations and demands rose such that there was no real difference in service levels between premium and marginal customers.
- ❖ This was partly fuelled by the fact that some existing premium customers also used the lower-priced products, and were the easiest to persuade to switch their business. Not only did they expect (and receive) the same level of technical and logistical service, but when the capacity was reached and it was time to price-clear some of this marginal business, they did not distinguish between the two streams, and worried that premium business was also at risk. Not only were price concessions necessary to calm them, but ABC's reputation for reliability and keeping its promises had taken a severe knock.
- ❖ The need to generate volume took the sales force further afield, for which they set up distributors, who by their nature sold on price and quick sales. The number of distributors grew until a separate managerial post was created to manage them, adding extra selling cost.
- ❖ The sales force grew used to being judged and rewarded by volume and contribution rather than profit, since a mix of premium and marginal business is the classic 'mixed message'. This reinforced the focus on the wrong sort of product, and the difficulty of dragging everyone back to what was truly important later.
- ❖ Meanwhile, the drive to grow the A1 market required extra product development effort and technical support in the field. This is normal and would expect to be funded by profits from the A2 products. Sadly the extra costs were evident, but the extra profits to pay for them were not; these departments had been expanded, whereas it should have

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been possible to divert unrewarding effort from elsewhere.

- ❖ The increase in sales generated a huge increase in order administration that was handled partly by an increase in IT capability and partly by increasing people. One might have expected an increase in one or the other, but as so many have experienced, it was otherwise!