

THE ROI OF MARGINAL ANALYSIS & SCENARIOS

by [Steve Brown](#)

From time to time, it can make sense to do some work around your house or remodel. Since bankers are always interested in getting a good return, we found research by Remodeling Magazine interesting. It itemizes the estimated ROI for various common home remodeling projects. In order, the biggest bang for the buck when remodeling comes from replacing an entry door (73%), followed by a minor kitchen remodel (72%); deck addition (70%); replacing a window (68%); basement (67%); major kitchen remodel (66%); bathroom (62%) and a roofing replacement (58%). If you are going to do any work on your home this year, we thought you might like to know where to spend your time to improve your return.

One way to improve your return on investment with your small business customers is to assist them in designing their business plans. This is also a concept of marginal analysis, a notion widely used in finance and the basis for modeling scenarios. A wide array of topics can be analyzed marginally (cost, utility, benefit, productivity, quantities of goods and services). For instance, measuring the marginal cost of a unit of manufactured product is the cost of the additional inputs needed to produce that unit. In simple form, this math can be done on a spreadsheet.

This topic is important because small businesses often begin shaping their business either by looking at forecasted revenues or by the cost of their initiative. Marginality is not a binary decision, because it provides information that can drive multiple scenarios, so it can also help fine tune the outcomes.

Suppose that your small business customer believes their company can expand revenues greatly by increasing production. This implies incorporating a new piece of equipment. Doing so costs money, so your customer wants to run scenarios that will help them forecast the outcomes to make a sound decision. You want to help, so initially, you might suggest they run a marginal benefit analysis. This means obtaining the difference between marginal revenues and marginal costs.

However, suppose that operating costs grow geometrically as the extra units are produced. Doing pre-analysis could reveal that all this effort leads to bad results. For instance, variable costs could rise because employees need to be paid overtime rates to produce extra units, or additional and more expensive rent may be needed to make room for more workers.

This is why the concept of marginality should be taken with great care. Marginal analysis does not provide explanations about the movements and behavior in all the variables involved. Rather, marginality is frequently misused in this sense. It requires moving a step forward, without stopping at the marginal benefit calculation. To help your customer answer the riddle, you might suggest they consider the relationship of marginal and average costs over time.

Consider that, in some markets, marginal cost can surpass average variable cost in the long run. That means businesses participating in the supply side may suffer diseconomies at certain volumes (shutdown points). Put another way, once they reach a certain inflection point, they could begin to run at a loss. Further, business owners will have to run the analysis to ensure the final price covers the costs. Many projects are driven by emotion or gut instinct, which can lead to disastrous results, so scenario testing can help introduce logical analysis. To do projects right, each should be planned with

attention to detail. The addition of a simple piece of equipment could have a broader impact than just more widget production. Other concepts such as "hidden costs" or "shadow prices" can arise after project kick-off and reduce customer profits, so educating them is in your best interest as much as it is theirs.

This is why your small business customer has your bank as a partner. By providing education alongside honest and transparent feedback, customer expansion ideas can be analyzed using theoretical and empirical research. It may seem a bit complex at first, but becoming their technical ally can help them run a better business over time. Give it a try to boost the ROI of your customer relationships.

BANK NEWS

Closures (2 YTD)

Regulators closed 1st Regents Bank (\$50mm, MN) and sold it to First Minnesota Bank (\$392mm, MN). First Minnesota captures 1 branch, all of the deposits (2% premium) and essentially all of the assets.

M&A

Liberty Bank (\$3.6B, CT) has entered into an agreement to buy The Bank of Southern Connecticut (\$122mm, CT) for \$11mm or about 1x book.

M&A

Eagle Bancshares Inc. (\$68mm, WI) will buy Eagle State Bank (\$16mm, NE) for an undisclosed sum. The president of Eagle Bancshares said he and other investors also own Brunswick State Bank (\$82mm, NE) and Tri Valley Bank (\$34mm, NE).

M&A Activity

SNL Financial reports 2012 saw 236 M&A deals among banks and thrifts vs. 178 in 2011, an increase of 33%.

Foreclosure Fine

British bank HSBC joined 12 other major banks and agreed to pay \$96mm in cash and \$153mm in other loan assistance to borrowers it foreclosed on during 2009 and 2010 (to correct for shoddy practices). All told, these 13 financial institutions have agreed to pay \$3.6B in cash and \$5.7B in other assistance to 4.2mm borrowers.

Malware Risk

Banks should note technology experts say the Shylock online banking malware has been updated to spread via Skype. The Trojan program steals online banking credentials and other financial information.

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