Opportunities for Action in Consumer Markets

Paying for Performance: An Overlooked Opportunity

THE BOSTON CONSULTING GROUP

Paying for Performance: An Overlooked Opportunity

Every time a sales representative considers which customers to pursue, how aggressively, with what mix of products and services, and at what prices, he or she is implementing the company's strategy—or working against it. Sales force deployment and compensation are, therefore, among the most strategic levers a company has to improve growth, market share, and profitability. If sales reps' compensation is not aligned with the company's strategy, the strategy will not be implemented.

A client of The Boston Consulting Group points out that "good sales reps will quickly strip apart a comp plan and figure out where to devote their time for maximum payout. They might not understand our strategy. They might not know very much about the product. They might not be willing to invest time to learn about the customer. But they seem to know intuitively what will put money in their pockets."

Few companies have payout schemes that are aligned with company growth and profitability. (See Exhibit 1.) In some companies, the compensation plan was not kept current with changing drivers of success. In other companies, the plan's original designers didn't fully understand the profitability and growth potential of all their products and customer segments. Yet most consumer companies could greatly improve sales and margins in less than six months if they would take the time to link their compensation systems with their strategy.

An effective compensation plan aligns sales force rewards with the company's goals, measures performance precisely and fairly, encourages salespeople to

stretch their efforts, and provides rewards that attract and retain the best performers. A poorly designed plan, by contrast, can unwittingly direct the sales force to focus on the wrong customers, encourage unnecessary discounting, and overpay for poor performance. It can also inhibit teamwork and discourage the sales force from taking the time to educate customers about new products.

The Price of a Misaligned Compensation Plan

Consider the case of a manufacturer whose revenues, market share, and margins were all declining, even though the company still owned the greatest share of

Exhibit 1. Payouts and Profits: The Misalignment of a Typical Sales Force

SOURCE: BCG analysis.

a concentrated market and its customers faced substantial switching costs in shifting to another vendor. The company had been unable to introduce profitable new upgrades to its existing customers, and it had been losing accounts to its competitors. Most of its problems, it turned out, could be traced to its compensation plan.

For example, sales rewards were based only on revenues (not profits) from sales of new systems and upgrades. The profit margin on upgrades, after selling costs, was much higher than for new systems. But because revenues from upgrades were only one-fifth of revenues from new systems and upgrades required more sales effort per dollar of revenue, the sales force pushed new systems rather than upgrades. Furthermore, because the salespeople were not compensated for service contracts, they focused their energies on selling large new systems. In many cases, that meant going after competitors' accounts rather than mining the company's customer base.

Selling new systems was difficult, however. And because it often involved winning over competitors' customers, who would face high switching costs, the company provided extra incentives for "customer conversions." (In one instance, a new Mercedes was awarded to the salesperson who converted the most customers of a specific competitor.) Moreover, the company had given the sales force substantial authority to determine prices. The cumulative effect of these features of the compensation system was to undermine the whole company. The sales force focused on competitors' accounts, ignored product upgrades in favor of high-ticket items, used price as a lever to overcome the switching barriers, and even started a price war. And because much of the sales force was ignoring the existing customer base, market share was falling.

Getting the Basics Right

A good incentive plan should answer three basic questions: Who is paid? How much are they paid? What level of performance are they paid for? Furthermore, the plan should reflect the company's strategy and the value it offers its customers. And it should be precise, fair, and simple.

By aligning incentives with strategy, the company ensures that the sales force focuses on the most attractive customers, selling them the right product mix at the right price. Precision is important because it guarantees that salespeople are rewarded only for those aspects of the selling process over which they have control. A fair plan means that equal stretch gets equal reward. And a plan that is simple, having no more than four or five components, will be easy to communicate to others. Precision, fairness, and simplicity are critical qualities because good salespeople tend also to be skilled cryptographers. They quickly decode any new compensation plan and figure out how to get the most out of it. When they do that with a precise, fair, and simple plan, however, they are also figuring out how the company will get the most out of the plan as well.

Design Logic

Understanding the basic goals of a compensation plan is challenge enough, but designing a program that carries them out can be a truly difficult task. All compensation systems involve a series of complex tradeoffs. How much of the compensation should be fixed and how much variable? Should it reward revenues, profit margins, or both? How will it weigh mature products against new ones? How will it encourage salespeople to stretch for incremental dol-

lars once they have hit their quotas? The right answers to these questions will balance the salesperson's primary concern ("Is my return worth the effort I put out?") with the company's performance, its strategic and financial goals, and the value it offers its customers. Here's how this tradeoff might be managed in three important compensation issues:

Balancing Volume and Margins. Many companies wrestle with whether to base compensation on revenues or profits (usually total gross-margin dollars). If salespeople are compensated for revenue only, they have a tendency to trade price for volume and to spend less time selling lower-ticket (but often more profitable) items. If they are compensated for gross-margin dollars, they are tempted to cut price on high-margin products in order to sell more of them (even if the market will bear the higher price), and they neglect low-margin products.

As a result, they forgo opportunities that might be less profitable to them personally but more profitable to the company overall. To avoid such practices, the company can create a payout matrix that rewards both revenue and margin targets. Although the matrix adds a little complexity, the sales force will have no trouble decoding it, and it offers an elegant way of achieving the volume-margin balance.

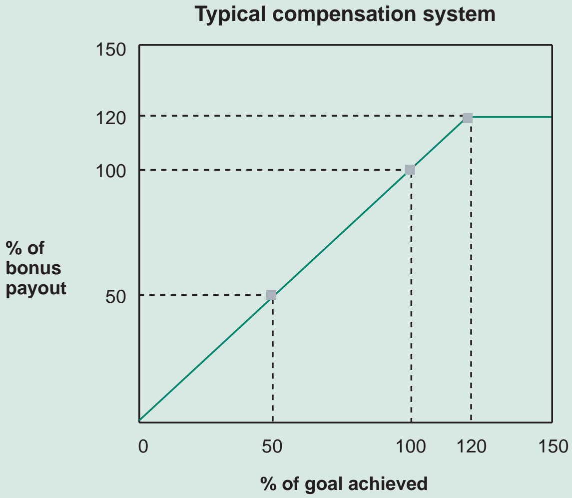
Managing the Product Portfolio. In most companies, salespeople have a bundle of products to sell. These products are at various points in their life cycle, so they have different levels of strategic importance and requirements for positioning; and selling them involves varying amounts of time for customer education. Unless the compensation plan reflects the strategy for each product, a salesperson might simply favor his or her own interest. That can have a huge impact on sales of products that are in the early years

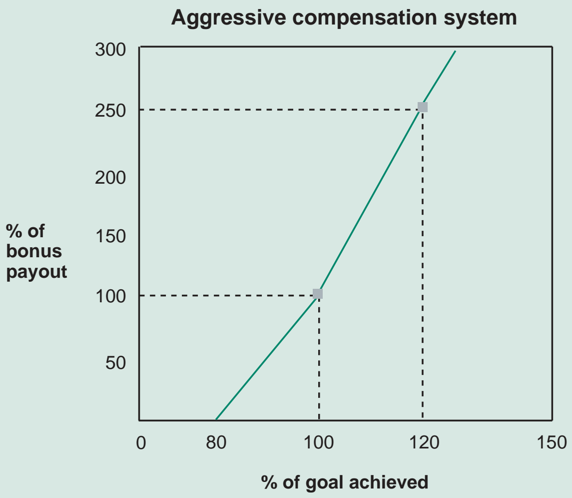
of their life cycle, when the sales effort per dollar of revenue can be high, as well as for products at the end of their cycle, when they require an extra push to keep sales moving. A good plan considers the return to the salesperson for each incremental hour of effort and adjusts the reward associated with each product to reflect the company's strategic objectives, the product's financial characteristics, and the customer's value proposition.

In a recent project, BCG's team asked salespeople to estimate the incremental rate they required for an incremental hour of work. Annual cash compensation for each rep working 46 hours per week averaged $47,000. The salespeople determined that for an additional $1,000 per year, they would devote an additional hour every week to new-product sales. The company was then able to set up a temporary incentive program aimed at increasing the time its sales force gave to its new product line.

Ensuring Stretch Performance. Many companies have compensation plans that pay out a portion of a bonus whenever a salesperson achieves a predetermined portion of his or her quota. For example, 50 percent of a quota earns 50 percent of a bonus, 75 percent earns 75 percent, and so forth until the full quota is reached. Exhibit 2 illustrates the difference between that approach and one that makes no payout until 80 percent of a quota is achieved. At that point, it increases the incremental return for sales beyond the quota. The problem with the former approach is that it inadvertently rewards underperformers—people who, for example, achieve only half of their quotas—and it encourages the stars to coast once they have reached their goals. A reward line with a steeper slope motivates sales reps to stretch to achieve the first 80 percent quickly and to keep stretching for additional rewards once they surpass their quotas.

Exhibit 2. An Aggressive Compensation System Can Stretch Performance





SOURCE: BCG analysis.

Design Process

Designing a compensation system is an iterative process that requires continuous testing and refining to ensure that the incremental return for each unit of sales effort is consistent with the company's goals. The first step is to gather clear data on the following:

- Product and customer profitability, after-selling costs, and adjustments for win rate
- Strategic objectives for each product
- The average sales effort required for each product
- Variability of sales performance and drivers of that performance
- Number of potential sales and length of the sales cycle (If a salesperson makes only two or three big sales a year, the company should introduce some form of multiyear averaging.)

Once the historical data are solid, the company can develop a number of plans for optimizing the incremental dollars per hour of sales effort. To understand how these plans might influence sales behavior, the company should test the plans with focus groups of salespeople. With the results of this research, the company can refine the plan that is most likely to achieve the desired results, develop communication and support tools, and roll out the program.

Indeed, this is the process the manufacturing company followed when it discovered that it could resolve most of its problems by revising its compensation system. The result was a plan that took into account all revenue sources—not just sales of new systems and upgrades—and awarded points on the basis of a

combination of revenues and profit margins. The company also addressed the requirements of products at various stages of their life cycle by applying multiplier factors to products that needed an extra sales push. And finally, it established a steeper reward-for-achievement slope. Working together, these revisions greatly improved the company's performance. The company stopped losing market share, pricing became more rational, and revenues per customer increased because the sales force was selling a greater range of products to existing customers.

* * *

If it has been some time since you last looked closely at your compensation system, chances are it no longer supports your strategy for providing value to your customers and achieving superior returns. Here are ten warning signs that could indicate that your compensation system needs an overhaul:

- Your highest-paid salespeople are not the ones who are generating the most profitability for the company

- You are losing share with your most attractive customers

- Price realization for similar types of customers varies widely

- You are having a hard time getting the sales force to sell the full range of your products

- Product introductions falter for lack of attention from the sales force

- You are paying more than 90 percent of the sales force some kind of bonus

- Salespeople stop selling as soon as they achieve their quotas

- To determine payout levels, you first need to process a lot of exceptions

- Customer complaints are rising, and they point to problems with the sales force

- No salesperson can make more than you do

Nearly every consumer-goods company doing business today could quickly and dramatically improve its bottom line by rethinking its sales force's compensation in light of its strategy, financial objectives, and the value it offers its customers. If you have doubts about alignment and congruence, invite your best and worst reps to lunch and ask them these questions:

- What are our least profitable and most profitable businesses, and how do they affect our selling efforts?

- What products are we pushing, and why are we pushing them?

- When you make more money, does the company make more money?

Paul Gordon

Paul Gordon is a vice president in the Chicago office of The Boston Consulting Group.

You may contact the author by e-mail at:
gordon.paul@bcg.com

© The Boston Consulting Group, Inc. 2001. All rights reserved.

THE BOSTON CONSULTING GROUP

Amsterdam
Athens
Atlanta
Auckland
Bangkok
Berlin
Boston
Brussels
Budapest
Buenos Aires
Chicago
Cologne
Copenhagen
Dallas
Düsseldorf
Frankfurt
Hamburg
Helsinki
Hong Kong
Istanbul
Jakarta
Kuala Lumpur
Lisbon
London
Los Angeles
Madrid
Melbourne
Mexico City
Milan
Monterrey
Moscow
Mumbai
Munich
New Delhi
New York
Oslo
Paris
San Francisco
São Paulo
Seoul
Shanghai
Singapore
Stockholm
Stuttgart
Sydney
Tokyo
Toronto
Vienna
Warsaw
Washington
Zürich

BCG

www.bcg.com

11/01