QUANTUM SALES COMPENSATION
How to Create a Powerful New Kind of Sales Incentive Plan

Good morning, everyone. It's Randy MacLean. I'm the president of WayPoint Analytics. Today we're going to start the first of our three-part series on Sales Compensation Design. The purpose of this series is to give you insights into how to put together a profit-based compensation plan for your company. This is very important because these plans are enormously effective in getting the sales force productive in profit production, rather than just bringing in sales, and they can change the profit performance of the company substantially. Companies that have planned and executed these kinds of programs together have seen very large profit increases generated when they get the best frames working with their customers, doing the things that generate profits that make the business better.

What we'd like to do over the next three half-hour sessions, we're going to talk about how a plan is designed, the kinds of things you need to know and think about, the proper steps of execution, as well as how to plan, how to program properly and how to execute it, and we're going to get right down to the plan mechanics by the time we get to the third session.

So the first session today will be the Fundamentals and Planning. We're going to be talking about the overview of what it is we're trying to accomplish, what's going on in the environment, and how the professionals deal with that when they're putting together a program, how they bring those elements into play and how they think about other things they're going to achieve.

The second session next week, we're going to talk about Plan Mechanics. That's going to be the session where we're going to be talking more about the numbers and how we calculate the numbers and how to go about the beginnings of designing the plan in detail so you know who's going to be paid what and how.

The third week we're going to get into the real detail. We're going to get right down to showing how to come up with the right numbers for your people, for your company so that the plan can work properly and so that you can avoid the mistakes that people make when they put plans together when they do it infrequently, as most of us do.

Off the top, I should tell you that this is an area that I spent a good deal of my life on. I've spent over eight years at probably the best or the top sales compensation design firm in the world. During that time, I spent a good deal of time working on projects for compensation for companies like IBM, Starbucks, Agilent, Unisource, and some of the largest companies. Where we operate it, if you weren't doing at least $100-200 million, you probably couldn't afford us, and the plans that we put together could run anywhere between $100-500 thousand in order to get the wisdom and advice of the people in our team so that you can have a plan that would meet its objectives and would function properly and would help you avoid the mistakes that a lot of people make that cause destruction in sales. So during the course of that time, I collected a great deal of the wisdom of some of the brightest people in that business and I'm able to share it with you during the course of the next three sessions.

Five Principles of a Good Sale

The first thing that we would tell people, or I would tell you, is that there are five principles of a good plan. These are very important and I want you to understand what these are so that when you're thinking about what you're going to do with your plans in the future, you'll be well-armed and can make sure that you're thinking about the things that matter.

1. Pay for Persuasion

   The first item is that sales compensation is supposed to pay for persuasion. It's very, very important: pay for persuasion. The whole purpose of having a sales force is to have a skilled set of people that can go to customers or potential customers and persuade them to do something different than they're doing right now. Whether that difference is coming and buying product from you if they are not doing so now, or it's a difference where they already are buying product from you but they're going to buy it in a different way or they're going to buy more of it or they're going to do something that is going to make for a win-win situation between the two companies. That's what we're supposed to be paying for.

   Because many of our companies have had long lives, we may have companies that are a decade or two decades or half-a-century or even a century old, a lot of the things that we do in sales have to do more with our tradition or history than this one basic fact and we lose sight of this kind of thing, where we have an account territory and somebody leaves or retires and then we find somebody else and plunk them into the territory, and at the time, we're just hoping that somebody's going to take over the territory and keep it alive and keep it going.

   Really the purpose of a salesperson is to go out and change the nature of a territory, so we always want to believe that we're paying for persuasion. We're paying salespeople to persuade our customers to do something different than what they're already doing. That's where the biggest part of the money should go.

2. Protect the Best Reps

   The second element of a well-designed plan is we're going to protect the best reps. Now when I talk about the best reps, I'm not talking about the guys that have necessarily been there the longest, although sometimes they are the best reps. I'm not talking about the guys that may be overseeing the best territories. I'm talking about the reps that do the most to produce new profits for the business. Those are the guys that are going to help us meet our objectives. Those are the guys that are going to help the company grow. They're going to give us increased cash flow, increased profitability and increased ability to do things that we can't do right now and give us a better future and help guarantee the safety and security of all the stakeholders in the company, whether they be the ownership of the company right down to the people that have wage or salaried jobs that would like them to continue.

So, we want to make sure that we're protecting the best reps. A good plan will always do that, will be able to recognize the people who are making the biggest contribution to the company. They will always come out as well as they have right now, or had, and people that improve their performance will come out ahead in a good plan. There are some elements that I will get into the discussions today and in the coming weeks, but suffice it to say that no good productive, profit-generating rep should ever be harmed by a good plan design or a plan that we designed properly.

3. Prevent Runaway Earnings

The third item is that we should prevent runaway earnings. One of the elements that we've all seen is we put a new plan together and they won't cover all the bases unfortunately but we don't know that we put it in. Sometime after the plan goes in, somebody walks in with a $10M sale, and the way that the plan is done, this salesman is going to walk away a millionaire. This can be problematic because there generally isn't enough profitability to make that happen, but if we have inappropriate mechanic in the plan somewhere, then we wind up with difficulty. So we'd always like to make sure that the plan prevents runaway earnings and anticipates the fact that there may be some windfall that comes in, and when that happens, that the profits generated by that sale is appropriately shared between the sales rep and the company, and the rep doesn't take all of it, or more.

4. Operate Within Budget

The fourth element that's very important is the plan should operate within the budget. One of the issues that people run into when they put together a plan and they can't test them properly is that they may wind up rewarding people in places where they maybe shouldn't and they may wind up with a situation where the plan costs the company more than was anticipated, and it can deeply affect the profitability of a wholesale distribution company. When you think of nominal companies running a 3-4% NBT, that means only 3-4 cents of every dollar that comes in as revenue makes it to the bottom line. Some error in the plan that causes it to scale up and instead of hanging out your traditional, say, 2.5M in sales or 25M in sales compensation, so you're paying out 30 or 40 or 50 million, then that's going to be problematic and cause difficulty for the company and the company's finances. So a good plan should always be able to operate within a budget, and when you get increased performance, you should be paying for that increased performance out of increased profitability.

5. Provide Performance Insurance

   Finally, a well-designed plan will provide performance insurance for the management of the company. A good plan will always anticipate that some people are going to underperform, but it will have a mechanism built into it that will incent other people to over-perform so they make up the numbers. We've all seen situations in the past where we have several branch managers that are doing well, they got the message and they're out there turning over rocks and doing very well and they get increased earnings because of it, but other branches may be underperforming and we have managers that are being bonused, but the regional management, the district management, the company president doesn't meet his objectives because there's no mechanism in there to make up for the inevitable underperformance that will happen somewhere within the plan, and that should be thought through. In a good plan, there will always be some mechanism that encourages over-performance where it's possible to a greater degree than we're going to have underperformance where it happens. So a good plan will always guarantee that the company's going to look good to the bank or to the finance sources, to the stakeholders of the company, and that the senior managers of the company will always meet their objectives and be able to meet or exceed their goals.

   So those are the five elements that you'd always want to have. They're the hallmark of a well-designed and well-executed plan.

Timeline

Now, from the 30,000-foot level, these are things that you're going to look through, look to, for the timeline of your plan.

1. Design Plan

   The first element is you're going to spend some time in the plan design phase. You're going to start gathering information about how the plan works now, how people are being paid now, what the performance in the company is now, what that means in terms of the profitability of the company now, and start to boil that down.

   For those of you that are using WayPoint, you're going to have very, very good information on NBC, which we'll talk about in a moment, so I'll leave the definition of that for a moment. It will also give you a good indicator of which territories, which kinds of customers, which kinds of products make the most money for the company, which ones do the opposite, and will give you the starting point for a philosophy of what it is you want to achieve.

Remember, what we are always looking for, what we're always trying to do, is drive change. We're always trying to make the company better, trying to make the bottom line better. The way that we're going to do that is by shifting the focus of the people that are driving the sales process and bringing the customers and different kinds of business into the company, and make sure that they're going after the things that are most productive, the most profitable, that make the biggest contribution, and we're going to be able to identify things that make no contribution, or make a negative contribution.

In those two segments, we're going to think about what it is that the company could be doing to either change the ratio of more money-making to less money-losing business and maybe just shift in emphasis in letting some of that business go, or it may be making a concerted effort to change the dynamics of the money-losing business to make it profitable as well so that we have more on to the bottom line.

So in the design phase, we're going to start by doing a lot of information gathering, start understanding the profit dynamics underlying the business, and within that area, we're going to get some pretty clear indicators of the things that we do that make a big contribution in a positive way, in which things wind up draining our profits away. Remembering key principle of quantum profit management or of the real math of wholesale distribution within the business is very, very important.

Within the business, you have a great deal of money-making transactions going on right now, but if you have an average profit line, that means that you have an almost as large a cadre of business that is draining those profits away before they get to the bottom line. The numbers here are pretty staggering. Most companies, whatever they bring to the bottom line, they had four to five times that in the best part of their business and up to 75-80% of it is being drained away by dysfunctional business. What we're trying to do is to get the sales force to help us shift emphasis so we do more good and less bad in the company. When we do that, we have the key to having a doubling or tripling of the bottom line.

We've seen examples throughout the time that we've been in business for the last seven years, where companies that have gone out and made those changes have produced, not a 20% increase in the profit, but 100 or 200 to 300%. We've seen examples where in a two-year period, a company has got six times the profit they had just two years ago, four times the profit they had two years ago, five times the profit they had two years ago. These things are available in every viable company because those dynamics exist everywhere, where most of the money that you're making in the best part of the business is being lost to dysfunctional business. So the real trick is to trade customers with your competitors and let them have the money-losing dogs in exchange for their best profit-making companies. What you're going to do is have the sales force incented to go and do that.

2. Test

   The second element is you need to test the plan. Whenever there's a failure of the compensation plan that causes management to have to run back and collapse the plan or back off the plan or abandon the plan, it's usually because it's had unintended consequences. In my history in the past, it was very, very expensive to back-test a plan. Companies would have to make a $120,000 to $150,000 decision to have our company go on test, back-test the plan by loading historical data and seeing what people would have made with their actual performance if the plan had been in place.

   The very cool thing about the WayPoint companies will be on this line as they have the ability to do that and it's still right into the system, so you will know exactly what everybody's performance is, you'll be able to apply exactly your new plan to it. On a rep-by-rep basis, you can pretty conveniently find out what they would have made on a month-by-month basis on a new plan and identify places where people have earnings that are too high or too low, and then adjust your plan accordingly to prevent those issues from cropping up after execution. So, testing the plan is the second element of your timeline.

3. Document

   Third element that's very important is you need to document the plan so everybody knows what the rules are, 'everybody' being the salespeople that are working under the plan so they know what it is they can do or not do that will affect their earnings; documenting properly for legal purposes of course; documenting so that the managers will understand what the plan is and can properly communicate and deal with plan questions as they go on; and then documenting effectively so that HR payroll knows how to implement the plan and do the calculations to make sure that people are properly paid.

4. Launch

   The fourth element or step in the timeline is to go through the launch. At the launch period, what you're going to do is to communicate the plan and help people understand what the plan is, discuss what the elements of the plan are, giving everybody a clear direction of how the plan is going to work for them, and what kinds of things they should or should not do if they want to affect their earnings, and certainly give them a view to the financial upside.

When I talk about the upside, we have another great example of a pretty sharp business operator that put a plan together and he was fully aware of the things that we're talking about here today. He was able to report at the APIC conference in March that his sales force across the board, on average, had a $30,000-a-year increase in their earnings by switching to a profit-based sales compensation plan, and then with the full support of management, they were out changing the dynamics of the business and selecting effectively a narrower and richer customer base that they were serving.

Not only did they produce substantial increases in the earnings of each of the sales reps in the company, they also tripled the bottom line of the business in one year. They did that by effectively moving away from over 400 of their previous accounts, not that they fired the accounts—I don't like the idea of firing accounts—but the idea was they started focusing on the things that really made the company money. They narrowed the service offering for people that were draining the bottom line away and they wound up going to the competition, paralyzing them. At the same time, they had a sales force that was freed up to spend much, much more time collecting, building rapport, and building a business with accounts that were more in their sweet spot and by giving better service to the best accounts that they have. It changed in less than a year, and enormously, the profit dynamics of the business with this kind of plan. The launch process was a very important part of that so that everybody understood how to use the plan and how to work the plan in their own favor.

5. Pay Calculation

   The final element is making sure that the pay calculation is in place and that there's a mechanism to accurately and on a timely basis compute the pay, and also an error correction process where if something goes wrong with the plan, there's a quick feedback so that course corrections can be made.

   So those are the five steps that you go through in timeline of a proper plan.

Customer Segmentation

Now we're going to talk about a couple of the elements of profitability. Some of you, certainly the people on the line that use WayPoint, will be familiar with this or probably are familiar with this.

The first element that is important in understanding the dynamics of the business is understanding how to do segmentation on profitability. This is an example of what WayPoint does under customer classification on the menus. Where it segments the customers, you understand within a territory or across the whole company or within a product line, which companies and what proportion of the companies generate the bulk of the profitability.

In this particular one, we're looking at a single sales territory where there are 17 accounts that are generating $81,000 NBC or the profit number that we're most interested in. When you compare that to 13,000 coming from 18 more profitable customers over here, and $102,000 loss from 86 small customers that are money-losing, and then another $113,000 loss from 13 more customers that are large-scale but are losing money, you start to see that within these four quadrants, there are some very different types of customers but they have a real impact to the bottom line.

Of course this is a money-losing territory where we got about $220,000 worth of losses in the money-losing accounts versus just $100,000 of profits in the money-making accounts. This is the territory we would like to start seeing turn around. What we'd like to do is to make sure that we're not paying commissions to sales people that are managing accounts that are losing money for the company or we're essentially draining the profits away from the business. We wouldn't want to enhance those losses by paying commissions on those accounts, and we would like to incent them to get more of the accounts at the top.

So the customer segmentation by profitability is an important dynamic that you should be considering when you're thinking about how to put the plan mechanics together and you'll see how this all relates when we get into the mechanics next week.

Whale Curve

The second element that is very important to think about from a philosophical or strategic standpoint is understanding the whale curves. This is illustrative of what's actually going on in the business. Those of you that haven't seen whale curves before, this is one of the most important dynamics in your business.

What we're looking at is a small business here. We just ranked all of the customers by profitability, so we start with zero and we put the most profitable on the second, third, fourth, fifth, and so on, until we run out of customers running down the left.

In the green band over here, we have all the customers that generate pretty fair amounts of profitability and they put large increments of profits on the bottom line of the company. When we look at this, we've got about $5M of profit coming from a little under 20% of the customers. These are the customers that pay the freight for everything in the company frankly. It also allows the company to manage losses elsewhere and still be profitable.

As an editorial comment, it's a little bit unfair that your best customers are paying high prices and making high margins so that you can essentially do business with their competitors in a way that they are taking profits away, they're imposing all kinds of costs on you, and you wouldn't want to go to the bank and borrow some money and just hand it to the customer. So effectively what you do is you take the profit that you make from somebody else and you hand it to their competitor. That kind of makes me queasy.

Along the back here, we have all of the small accounts that make or lose a few dollars and then we start getting into the bottom end of the ranking list where you have significant accounts that are losing bigger and bigger parts of the business. What's really going on here is there's $1.3M bottom line for this company. The president is probably thinking, "Wow, if I get a 15% gain next year and get it up to $1.5M, I'd be styling", when really there's $5.5M of profitability in the business right now, but most of it is being lost because they are over-serving or we have a cadre of customers over here that are consuming more resources than they are paying for. Changing this dynamic is something that can significantly increase profitability.

If we can just cut the losses on the money-losing business in half, the profit line in this business goes from $1.2M to $3.5M. So it almost triples the bottom line if we can just cut the losses in half of the company so they're not draining our resources. This is one of the things that we'd like the salespeople to do when they're negotiating pricing. We want to be balancing off margins versus costs so that the sales are in balance. So that's part of what we're trying to achieve.

So the two things are: We want to have fewer service-draining accounts and move them into the core accounts by making them profitable, we want to have fewer marginal accounts to make sure we're not paying profits or paying commissions on anything that's unprofitable, and we want to find ways of moving people ever up into the core area so that territories are more profitable. So recognizing these four quadrants and then having an action plan for each of them and a sales compensation plan that backs that up and encourages salesmen to do the right kind of thing can also prevent us from paying compensation or incentives on money-losing business. That's one of the first elements that we want to look at.

And then the second dynamic is we want to understand that if there's customers we're losing money, we want to cut the losses and we want to hang on to more of the profitable business we do. We'd also like to understand what populates this part of the whale curve and get more of that kind of business. That's the key to companies producing profit gains that double and triple and gets companies into the upper tier of the industry.

The Sales Comp P&L

Very quickly, I just want to take a look at the way that we structure a P&L sheet to come up with this NBC number. In most P&L sheets, we have revenue less costs, that gives us gross profit, and then because sales is the first thing in the logistics chain, we take the commissions and the sales costs and other expenses, we wind up with some profit – we hope.

Under quantum profit management and in WayPoint, the reports are structured slightly differently. We have revenue less costs, that gives us gross profit, and then we have all of our operating expenses, excluding the sales compensation, all of the pay for the salespeople that face the customers, for people that go out and capture customers. Sometimes they are inside people; sometimes they are outside people. Your particular dynamic will dictate what it is, but there's somebody out there that is being paid to have an interface with the customer and is being paid hopefully to persuade the companies to buy from us, buy more from us, buy more profitably from us.

Those people should be excluded from the calculation and their pay should be excluded. So that gives us the NBC number, Net Before Compensation. Then we take the sales commissions or sales pay out and that gives us the bottom line.

There are a couple of reasons why we want this NBC number. The first thing is this number can be thought of as the amount of money that we have after we've procured and paid for the product, run it through our entire operation, and it's the amount of money that we have left to share with the sales rep. so we'd like to know what that number is.

Second and very important reason for having the NBC number is that the sales pay is usually not a profitability problem and we don't want their pay to be affecting the NBC number. We're trying to measure everything on what we're measuring the whole company on, so we're leaving that out of the mix.

The third and most important reason, in the context of what we're talking about today, is it gives us an ability to pay profit-based compensation. The problem we're trying to pay on the bottom line over here is that the sales pay is part of the bottom line and the more you pay out, the lower the bottom line is. You want it where a circular calculation is pretty much impossible to figure out what's going on. If you isolate it in this way, the pay plans, which could be very complex in my previous life, are very simple for us because we can just decide that we're going to split this with them 60-40, 50-50, 70-30, whatever the case may be. What we're overdoing is we're figuring out how to make the split and then the amount that we pay out will affect the bottom line but it doesn't affect the NBC that we used as the basis of the calculations.

Gross Profit Commission Plan

All right, here's what's going on and why it's important. This red line is the trend line from a lot of actual data that we pulled on the system. It shows what the pay is on a typical gross profit commission plan. We have things like load factors to help protect us from paying more than we should. Sometimes we have commission clawbacks, sometimes we have thresholds or minimums. Unless there's a certain amount of profitability on a sale, we're not going to pay any commission.

Essentially this is what happens: As the gross profit on the sale—as this pink line occurs—we pay or may not pay a certain amount of commission. We sort of ranked them all here by the amount of commission that we pay and the gross profit can be greater or narrower. But it seems like we always wind up paying something on a sale; there are very few instances where nothing is paid. Although the mechanic would suggest that, we're trying to prevent those kinds of things, and so is a salesperson, so we can wind up people just on the threshold of being paid.

This blue line though shows what the NBC on the sale is. It's how much money the company has left to split with the sales force. As these commissions tend to come down, down, down, down and we pay small amounts of commission on the sale, we wind up having a profit line continue right below underwater. So effectively, what we have is an entire section on a plan where we reward the sales reps by paying them in cases where the company cannot possibly make money—and the gross profit here below, about $100, you can't cover your operating expenses on a warehouse pick and delivery—but we may still be paying commission, and so we have a big gap in here where we're effectively paying the salespeople to lose us money on a typical commission plan.

NBC Commission Plan

What we'd like to do is have the commission plan track the profitability. We'd like to be able to pay somebody on a sale; even if it makes a dollar, then they can be paid on it. But on the other side, if the sale goes underwater, the commission should go underwater as well. Now we shouldn't have a situation where the salesperson can leave the company holding the bag on a sale. That's going to cost a good deal of money. So, a good NBC program is going to have those things tracked.

So we're going to talk about NBC Commission Plan and we're going to get into this next week. But the preview is we're going to recommend a plan that's tied to the NBC. It's going to allow for a negative commissions, it's going to scale through the performance range, and one of the side effects is it's going to be very, very simple to operate.

So what I'm going to do is I'm going to hold it there and we'll pick this up next week. We're going to talk about the elements of the plan, we're going to take a look at a couple of reps and how they do, and then we're going to get into the way that we design plan mechanics and what kind of mechanics should be.

So I want to thank you for spending time with me this morning. I'm really looking forward to the next phase where we get to have some fun looking at some real numbers and how this is done, and then we'll finish up in two weeks hence, working out an actual plan and with actual numbers.

So thanks a lot, have a great day, and we'll see you next time.