



Paying For Performance

How compensation can have a direct effect on channel behavior

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The "carrot and stick" approach to getting results from a sales channel -- or paying for performance -- is about as old as the practice of paying sales channel partners to represent you in the market. And the four basic types of pay for performance are pretty universal as well:

1. **Results-based.** Achieve a certain volume or growth rate for your pay.
2. **Activity-based.** Conduct a specific activity, like training your sales force, and get paid more.
3. **Customer-based.** Sell to a specific customer type and get paid more.
4. **Relationship-based.** Commit to a certain degree of loyalty, like not representing competitive product lines, and get paid even more.

What isn't as well understood or as universally accepted by channel partners is that pay for performance is also about values -- the values of the supplier (e.g., to increase margins, to be paid on time, etc.) and the expectations of the customer (e.g. 100% satisfaction, one-stop shopping, etc.) Put more bluntly, channel partners need to understand that they're being compensated to help you increase margins, grow sales, and satisfy end-user customers -- not just to sell!

In this light, your channel pricing strategy, and the individual elements of your channel pricing plan, must be weighed according to the likelihood that they can help you achieve your values/business goals and the expectations of end-user customers. If they're not, chances are that you're missing an opportunity to use chan-

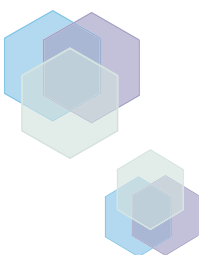
nel compensation to motivate channel behavior and achieve the results you're paying for.

A Few Words About Human Behavior

First, be careful what you ask for. When you use a channel compensation plan to tell your channel partners what to do, chances are they'll do it! And that includes changing their behavior -- for good or for bad -- to achieve the results you say you're compensating them for. Let's take a look at what we mean by good and bad channel pricing behavior.

Good behavior. If you tell a channel partner that he has to train all of his sales employees on your product lines in order to receive a certain level of compensation, he'll change his behavior and conduct the training. That's because distributors are supportive of the concept of investing in capabilities that differentiate them from their competitors and thereby earn them differentiated pricing. It creates a win-win situation: you get more effective sales representation and your channel partner gets the differentiated pricing he wants.

Bad behavior. If all you tell a channel partner is that he has to achieve 15% growth in order to receive a certain level of compensation, he'll change his behavior to do just that. But the change in behavior could be for the worse. The sales that are achieved might be at the expense of customer satisfaction, quality orders, receivables, returns, etc. Often, the increased sales can represent a shift in volume from one of your other distributors, resulting in flat sales to you, at a lower margin. In other words, the growth you pay the channel partner to generate might be completely contrary to





your values and end-user customer expectations.

Tie Compensation to Specific Business Goals

There are a number of incentives or penalties that suppliers use to encourage certain types of channel partner behavior, as illustrated in Figure 1. Of course, not using any one of these incentives or penalties can have the opposite effect by encouraging the channel partner to exhibit the opposite behavior.

Figure 1 -- Activity-based Compensation

| Incentive/Penalty | Active/Desired Behavior |
|---------------------------------------|--------------------------------|
| Co-op advertising allowances | Prompt product lines |
| Prompt payment terms | Pay promptly |
| Drop- or direct-ship order surcharges | Ship from inventory |
| Specification discount | Reward spec writing |
| Expediting order fees | Stock what your customers need |
| Restocking fees | Stock what your customers need |
| Small order penalties | Better forecasting/planning |

Suppliers often have to address three issues when they employ an activity-based channel compensation system.

First, unless specifically explained, channel partners often do not tie the discount received from the supplier to the activities the supplier has asked them to perform. Channel partners don't see the value in the activities (and focus on the costs of the activities), and the supplier loses the opportunity to reinforce the values/achieve the goals that the activities were originally created to address.

Second, many suppliers don't differentiate the various activities -- and the relative discount amounts that are attached to the activities -- from one another. As a result, channel partners often put more effort into capitalizing on a 2%

co-op advertising allowance than they do on the key activities that earn them the supplier's base discount (e.g., the 40% off list they receive for activities such as inventory, order handling, credit/collections, showroom displays, etc.). We have found that the channel partners that do perform the activities you desire would like to be differentiated/rewarded for their support (vs. those that do NOT perform the activities).

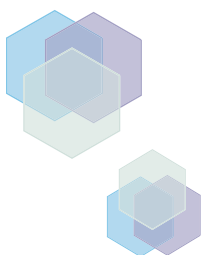
Third, and closely related to the first issue, many suppliers do not "enforce" the activity elements of their compensation systems by taking discounts away when they're not earned. As a result, they pay for performance that is not earned and forfeit the corresponding margin dollars. One of the values of assigning discounts to activities is that the supplier can take away a discount element instead of yelling and screaming or terminating the channel partner. Figure 2 illustrates how a supplier can lose ten points of margin when he does not adjust the channel partner's margin for a drop-ship order.

Figure 2 -- Variable Cost-Transfer Functions

| | Inventory Business | Drop-ship Business |
|----------------------|--------------------|--------------------|
| Inventory Value | 10% | -- |
| Sales Value | 8% | 8% |
| Order Handling Value | 4% | 4% |
| Credit Value | <u>3%</u> | <u>3%</u> |
| Margin Value | 25% | 15% |

Focus On The "Big Picture"

Supplier compensation systems must look at the entire amount that is paid to channel partners and make each activity generate the performance that the supplier and customer expect -- preferably in proportion to the economic value offered for each activity.





One method of realizing this result is to force channel partners to concentrate on the base discount that the supplier offers (i.e., the standard 40% off list) and the activities that warrant that base discount. Meeting the requirements of that base discount earns the channel partner a certain status -- perhaps as a "silver" partner. Failure to comply with these requirements results in loss of the base discount and status. Additional performance activities that the supplier offers the channel partner -- above and beyond base discount requirements -- earn the channel partner additional discounts off the base discount and loftier status levels -- perhaps as a "gold" or "platinum" partner.

pensation plan that further focus channel partners on specific, desired behaviors. Last, by "enforcing" the activities that channel partners are being compensated to conduct and having a mechanism in place to prevent margin dollars from being paid to channel partners that do not earn them.

How much "bang for the buck" are you getting from your channel compensation system? And how can you modify your compensation system to change sales channel behavior? To discuss these and other pay for performance issues, contact John Henderson at 312.558.4828 or hendy@franklynn.com.



History shows that carefully planned channel compensation systems can dramatically change behavior -- often times by merely re-focusing channel partners on the activities that the supplier or end-user customer place particular value on. For example, one supplier that was frustrated by his channel partners' refusal to conduct sales force training, encouraged his distributors to pay attention to training by withholding 1% of the base discount. His explanation was that one point of the base discount was for training that wasn't being conducted. What was the outcome? Within four months, the supplier's channel partners properly trained more than 1,000 sales personnel and went on to earn the additional one point of discount from the supplier.

Summary

Carefully planned channel compensation systems do more than motivate channel partners to sell. They also consider the values of the supplier and the expectations of the end-user customer and reward channel partners for helping achieve those goals. How?

First, by taking into account the supplier's base discount and the activities that channel partners must conduct to achieve that base pricing level. Second, by adding activities to the com-

