

OPEXEngine

News from the Operating Front

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A Closer Look at Sales Incentive Plans

Balancing Revenue Growth and Expense

Executives often ask me, "what is the perfect sales compensation structure for software companies?" Sales, for most software companies, comprises the largest percentage of operating expense - typically 30% of revenue for most mid-sized companies, and as high as 50-60% of revenue for high growth vendors, according to OPEXEngine's 2008 Software Operating Benchmarks. There are also outliers like Success Factors which spent more than 100% of 2007 revenues on Sales and Marketing. Within Sales, compensation represents the vast majority of sales expense. According to our benchmarks, total compensation and benefits averages approximately 74% of total sales expense for mid-sized software vendors. Sales travel is the next largest component, typically comprising 8-9% of sales expense for mid-sized software companies.

One of the biggest challenges is ensuring that a sales compensation plan effectively motivates sales performers to generate revenue in alignment with corporate goals, yet does not disproportionately escalate the cost of sales. Sales plans must motivate the sales team to bring in the most revenue, pay the highest performers a competitive package, while not paying too much to under-performers. This has to be accomplished while keeping all customer facing headcount aligned towards achieving corporate goals and minimizing disputes about pay-outs. In addition to working with a large number of mid-sized software vendors at OPEXEngine, I managed sales organizations in the US and Europe for 20 years. Several core principals can be found in all successful sales incentive programs that I have encountered. And while selling software as a service adds some complexity to the issue, the basic principles of good incentive plans still apply.

Motivate Performance To Achieve Corporate Goals

When designing a sales compensation structure, it is critical to first determine which company objectives are most important around which to incent performance. Is the

company primarily focused on adding new customers, managing and upselling existing customers, and/or working with partners? If corporate goals are not aligned with sales incentives or if the plan tries to promote too many objectives, the results will be unclear or even negative. A good plan will result in the performance it encourages. If the company incentivizes "bad" behavior, it is not the fault of the sales people. High performing sales people will always try to maximize their earnings. The issue for many companies is being clear about what to incentivize: Fast revenue growth or high margin sales? Customer satisfaction and renewals or breaking into new markets? Direct sales or coordination and support of partners? The success of the plan should be measured concretely in terms of the goals stated in the plan. To be clear about what is being incentivized, it is also important to establish who in the organization is the biggest influencer on each sale, who does the negotiations, and who closes the deals? The largest total package and upside opportunity should go to those salespeople who do the "heavy lifting".

What is the MARGIN of error?

Secondly, sales incentive plans need to incorporate a sales margin that is aligned with corporate goals. For example, if the corporate strategy is to grow at any expense, go after new markets and/or hit the competition, it needs to be done with management understanding of how the growth strategy will affect the cost of sales. For example, does the compensation plan encourage unintended discounting? Larry D'Angelo, VP of Business Operations at Makana Solutions (www.makanasolutions.com), a sales compensation software vendor, describes companies he's known that were so focused on motivating the sales force to sell a large volume of software subscriptions that a byproduct was massive discounting. In this case, quota achievement was determined by number of seats sold, regardless of margin. As a result the cost per subscriber remained extremely high even though the number of subscribers grew exponentially. A better option would have been to incentivize subscription sales, but only at an acceptable margin.

The cost of renewals is another key element affecting the sales margin. Is the plan paying the same margin for renewals as for new business? Once renewals become a significant portion of revenues, the cost of closing renewal business should be significantly lower than the cost of obtaining new business. It may not matter much at an early stage when there is little recurring revenue. Yet, once there is a significant portion of monthly recurring revenue, companies should separate renewals from new sales headcount so that renewals are handled by lower cost, highly leveraged personnel.

For example, if the cost of products for new customers is 30% and the cost of product for renewals is 18%, it becomes apparent why renewals should be handled by different sales people. The margin discrepancy can be attributed to more efficient and lower cost sales of renewals. As renewal revenue becomes a significant portion of total revenues, the overall cost of revenues will drop significantly. This is especially relevant for SaaS companies which need to drive down the cost per subscriber, a key metric for achieving profitability.

Clear and Consistent Role Definition

Another basic principle of good incentive plans is having clear and consistent definitions across job roles and departments - between business development and sales, between professional services and sales, or even within the sales organization. This is even more germane in the SaaS world. It is very common for companies to build compensation plans in silos without ensuring consistency across the company, according to Liz Cobb, founder and CEO of Makana Solutions, who's compensation software provides a framework for designing coordinated incentive compensation plans incorporating best practices. Lack of coordination can increase the cost of sales astronomically. For example, if sales is compensated entirely on revenue and services is paid on margin, when sales closes a large services deal with low margin, there will be conflict between the two groups. This can result in a badly managed project, less customer satisfaction, poor margin and sometimes even less revenue recognized than planned.

As companies grow, roles need to be more clearly delineated. This is especially true today. When compensation plans are open to interpretation, litigation arises around sales compensation disputes and it seems to be favoring the sales rep more than before. Clarity of incentive pay-outs should evolve as the company grows. Disputes that were easily worked out when the company was smaller, and when the sales team all knew each other, are not so easy to resolve with geographically disbursed teams that only meet once a year. As teams grow internationally and work together on multi-national deals, disputes may also be affected by underlying cultural sensitivities regarding who does the most work, who is critical to the deal, or whose market is the most important or highest growth.

Big Game Hunters or Master Chefs

Sales compensation strategies are just as complex in the SaaS world. Effective coordination of the multiple job roles involved in closing and supporting the customer is core to the nature of the SaaS business model. SaaS vendors leverage everyone possible in a coordinated way to have the greatest affect on the cost of sales. Ineffective coordination results in lower renewal rates and other inefficiencies which drag down successful SaaS financial performance. We used to describe top sales people in the enterprise world as elephant hunters bagging the big trophy. Today, one thinks of a master chef orchestrating a menu that needs to be delivered every day to happy and hungry customers.

About OPEXEngine

OPEXEngine works with high technology companies to develop comprehensive operating benchmarks that enable them to manage and plan their businesses more efficiently. Our mission is to deliver useful operating information to help drive profitability and revenue growth. We work closely with our clients to ensure that data and reporting are relevant to their individual needs. OPEXEngine was founded by operating executives with decades of experience in finance, sales, marketing, and general management of technology companies.

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