



IS YOUR SALES FORCE A BARRIER TO MORE PROFITABLE PRICING...OR IS IT YOU?

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One of the most difficult pricing challenges facing marketers is how to maintain consistent, value-based street prices in highly competitive markets where every deal is seemingly at risk. For many, the temptation to maintain flexible pricing policies in order to negotiate customer-specific deals is too much to resist. Like a dieter trying to lose weight, these marketers try to “cheat” by treating themselves to a one-time price discount to close a particular deal. However, just like the dieter who must face the reality of the scale at the end of the week, price cheaters must face the reality of their bottom line. Unfortunately, that reality all too often is characterized by increasing price erosion and decreasing margins.

Companies that do not manage their pricing by policy will, in most markets, lose control of it. In the process, they risk alienating their best customers, slowing the sales process and eroding profitability. It happens because customers’ willingness to pay for a product or service depends not only on their perceived value of it, but also on the expectations customers form about the need to pay for the value they receive. Sound policies create expectations on the part of each customer that the price they are asked to pay is determined objectively and has some relationship to the value received and/or the cost to serve. Unsound or nonexistent policies lead buyers to expect that they can manipulate information or

their own behavior to win discounts without giving anything of value in return.

A common fear for managers who are replacing ad hoc discounting with transparent and consistent pricing policies is that sales reps will not accept the change. While a minority might not make the transition, most will accept the change if it is implemented well. Sales reps don’t like being beaten up over price, don’t like the long sales cycles that reactive price negotiations cause, and don’t like having to spend their time making the case for discounts internally. Sales reps are motivated when management stands with them in resisting bad deals, and empowers them with the authority to cut good deals consistent with pre-approved policies. Interestingly, neither do most customers enjoy manipulative, drawn out price negotiations. They do it to survive suppliers whom they believe will exploit open, loyal customers.

When companies fully define pricing policies, their sales reps can have full authority to offer even the deepest discounts, subject to rigid constraints based on the customer characteristics and behaviors allowing a customer to qualify for them. For example, when confronted by a customer demanding a lower price to meet competition from an Asian supplier, the policy-empowered sales rep would not need

to appeal to a higher level of management to authorize a lower price, thus delaying the sales process and risking the deal. Instead, the rep could say, for example, that the company would grant a discount of 20% if the customer committed to volumes months in advance, just as the Asian supplier would require. Perhaps the customer might still decide to fill most his needs from Asia, but would want a contract with the company to cover just the amounts that might be required to meet short-term variations in demand. In that case, the sales rep would inform the customer of his company's policy to supply product in those situations only at spot prices, sympathizing with the customer but assuring him that price commitments require corresponding volume commitments.

The effects of pricing by policy are almost universally desirable. Customers learn that there is no reward for simply beating on the supplier, and that there is no need to fear that a competitor is getting a better deal. Consequently, customers lose the incentive to keep sellers in the dark about their true needs and the value of them. They also learn that there are trade-offs between the prices they pay and what they get. This process of "give-get negotiation" forces customers, even purchasing agents, to learn what their organizations really value. If policies are designed well, they drive changes in customer behavior that reduce your cost to serve them.

Good policies will make it easier for sales reps to resist pure price negotiation and to align price paid with value received. Sales reps, however, need to believe that those are necessary and valuable objectives for them, not just for their company. The first step in that direction, even before policies are in place, is to measure and reward salespeople for driving profitability, not just revenue. Many companies reward salespeople for making larger and more frequent sales, not for making more profitable sales. Unfortunately, giving salespeople revenue-based incentives and empowering them to negotiate prices is a toxic combination that poisons their motivation to sell value.

Consider the dilemma facing sales representatives who are compensated as a percentage of sales. Say that the company's margin is 10% on high-volume deals. A sales rep who invests a great deal of time with the account, selling value and/or getting the customer to change behaviors that drive up costs, might at best be able to increase the profit earned on the deal by an additional 10% of sales, doubling the profitability. Even if all that increase is in price, however, his revenue-based commission increases by, at most, 10%. In contrast, instead of trying to sell value, one of his colleagues spends the same amount of time selling two deals of equal size with only a 10% margin. As a result, the colleague's effort increases the company's profit contribution by the same amount, but he earns twice as much commission for doing so. Even if the colleague has to cut the price by 5% to win the deal, reducing the profit by half, he gets a bigger commission than the first sales rep who spent time selling value rather than volume, and as a result has to hear about his failure to keep pace!

Until you fix these perverse incentives associated with revenue-based measurement and compensation—driving revenue at the expense of profit—it will be difficult to get sales reps to do the right thing. The key to aligning sales incentives with those of the company is to link compensation with profitability using a contribution margin-based *profitability factor*. More than just theory, paying for profitability provides mutually beneficial sales incentives, and it encourages salespeople to pay more attention to value drivers beyond price such as innovative product features, quality defects and delivery speed. Once the company aligns sales incentives, salespeople will begin clamoring for the other things they need to succeed. At one company, for example, sales reps traded in their company sedans for vehicles in which they could transport product to new customers with an urgent need.

Creating a Sales Incentive to Drive Profit

The key to inducing the sales force to sell value and maintain price discipline is to

measure their performance and compensate them not just for sales volume, but for profit contribution. Although some companies have achieved this by adding Rube Goldberg-like complexity to their compensation scheme, there is a fairly simple, intuitive way to accomplish the same objective. Give salespeople sales goals as before, but tell them that the sales goals are set at “target” prices. If they sell at prices below or above the “target,” the sales credit they earn will be adjusted by the profitability of the sale.

The key to determining the sales credit that someone would earn for making a sale is calculating the *profitability factor* for each class of product. To encourage salespeople to maximize their contribution to the firm, actual sales revenue should be adjusted by that profitability factor (called the sales “kicker”) to determine the sales credit. Here is the formula:

$$\text{Sales Credit} = [\text{Target Price} - k(\text{Target Price} - \text{Actual Price})] \times \text{Units Sold}$$

where k is the profitability factor (or “kicker”)

The profitability factor should equal 1 divided by the product’s percentage contribution margin at the target price, in order to calculate sales credits varying proportionally to the product’s profitability. For example, when the contribution margin is 20%, the profitability factor equals 5 (1.0 / 0.20). When a salesperson grants a 15% price discount, the discount is multiplied by the profitability factor of 5, reducing the sales credit by 75% rather than by 15% had there been no profitability adjustment. Consequently, when \$1,000 worth of product is sold for \$850, it produces only \$250 of sales credit. But when \$500 worth of product is sold for \$550 (a 10% price premium), the salesperson earns \$750 of sales credit

(\$500 + 5 x \$50). Obviously, the importance of this adjustment is directly related to the variable contribution margin. The larger the margin and, presumably, the greater the product’s importance to the firm, the greater the profitability factor’s ability to align what is good for the salesperson with what is good for the company.

Conclusion

Profit-based sales incentives are not merely theory. As companies have moved toward more negotiated pricing, many have adopted this scheme in markets as diverse as office equipment, market research services, and door-to-door sales. Although a small percentage of salespeople cannot make the transition to value selling and profit-based compensation, most embrace it with enthusiasm. However, senior managers must lead this change; sales will not do it on their own. Company leaders must develop the appropriate policies, metrics and incentives that align the sales force to measures of profitability. In making this change, however, managers should also be prepared for some unexpected consequences as salespeople begin to focus more on profits and less on volume. Now, salespeople who previously fretted about the company’s high prices will begin complaining about slow deliveries, quality defects, lack of innovative product features, and the need for better sales support to demonstrate value. The sales force’s attention will move from reflexive complaints about price to legitimate concerns about value drivers the company does or (does not) provide to customers. It will be a change so conspicuous you’ll know you’re on the right track.



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