The PRICING ADVISOR
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How to Build Effective Channel Compensation Systems

The effectiveness of channel pricing systems often comes down to the ability of suppliers to answer four key questions correctly: whom to pay; how much to pay; what to pay for; and, how to structure the pay. This article explores how companies can ensure they come up with the right answers and avoid misdirecting resources unprofitably. The author, Sam Shapiro, is the president of Channel Pricing Associates, a consulting firm which specializes in helping manufacturers and suppliers develop pricing, rebate and other programs to motivate their channel partners. For more information, please contact Sam at: info@channelpricing.com.

What is Channel Compensation?

Sometimes, suppliers get caught up in thinking that channel compensation consists solely of their back-end rebate programs and market development funds (MDF). These programs have a high level of visibility since they show up clearly as line items on the supplier's income statement. To really understand a channel's overall compensation, a company needs to consider the front-end margin that the channel earns in addition to the back-end programs.

Take, for example, a supplier with sales of $100 million. It is typical for firms across industries to provide back-end rebates in the range of 3% to 5%. Of course, in some sectors rebates can reach levels of 20% or higher. In addition, there are often market development funds or coop advertising programs that cost an additional 1%. At first blush, in our example, back-end channel compensation for our supplier costs approximately $5 million on $100 million in sales.

If the channel adds a 20% front-end margin to the supplier's $100 million in sales, total sales are $125 million. When we add the $25 million in front-end margin to the $5 million in back-end programs, this supplier allows its channel partners to earn a total of $30 million on $100 million of its own sales. With the exception of special programs such as financing, fees or other less common approaches, this is a good baseline for determining whether a supplier is over- or undercompensating a channel.

What Motivates Channel Behavior?

A supplier could offer a distributor huge discounts and massive rebates with no impact at all on behavior. Here are the factors that have the greatest impact, listed in order of importance. These include:

Customer Need. A reseller will source what its customers require. This gets to the heart of the channel's role. Most channel partners are not out developing new applications. As a supplier, it is likely that you are wasting your resources if you are paying your channel to create need where none exists.

Customer Demand. **Many suppliers have their own sales force or tools to generate demand that is then fulfilled by the channel. The best way to ensure that a partner supports your brand is to go out and sell it for them. A brutally honest manager for a distributor recently summed it up this way to a client: "Why should we bring in your line if you're not going to sell it for us!"**

Product and Service Business Model. Product margins may be irrelevant to a channel that operates primarily to offer services. The importance of a line to the channel's business determines significantly how much compensation it will take to motivate behavior.

Customer Preference. This is similar to Customer Demand. However in this case, the customer is not pre-sold, but indicates a brand preference. If a customer asks for Brand A, all things being equal, the distributor will sell brand A due to the switching costs.

Inventory Investment. Distributors sell what they stock. It's an old school axiom that a "loaded distributor is a loyal distributor." Suppliers must carefully consider whether to drive inventory onto the shelf. Doing so increases the likelihood of sale as distributors seek to turn their inventory. Excessive loading, however, increases supply chain costs both for the channel and the supplier, while eroding margins through forward buying.

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Relationships. Predictably, friendly sales reps can be a major asset in cementing the bonds with distributors. Suppliers can pay less if they maintain good and trusting interactions with their channel partners. Conversely, in some cases, no amount of compensation will overcome a poor supplier-channel relationship.

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Price. **Most channel sales reps do not present a higher priced option to customers if it puts them at risk of losing the sale. When designing a compensation system, you must determine whether the system will compensate for an over-priced offering–or one that is priced too low.** Ideally, of course, suppliers will ensure their compensation systems drive their reps to the desired behavior.

Sound Decisions Require Answering the Right Questions
Suppliers should ask four key questions as they develop their compensation programs:

Whom to pay?
How much to pay?
What to pay for?
How to structure the pay?

Not all channel partners are created equal. Suppliers must determine whether to do business with many–or a select few. For example, in construction products, should all suppliers do business with big box retail and specialty distribution?

The number and type of partners that a supplier goes to market with impacts the amount of channel conflict in the system. As we've noted previously, sales representatives are compensated based on the margins that they return. A reduction in margin due to excessive conflict will erode selling effort by the channel. Other factors that affect conflict levels include:

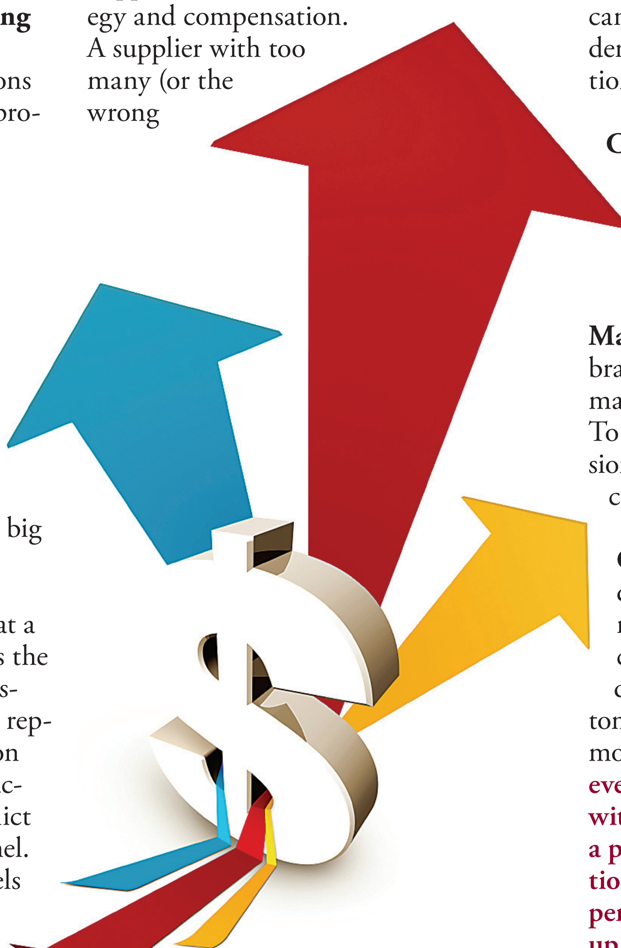
Demand for the Brand. Channel partners will sell what customers ask for and therefore strong brands generate higher levels of conflict.

Distribution Costs. Products with low freight fees are easier to ship across geographical boundaries and therefore can generate more conflict.

The Channel's Business Model. Some resellers apply low product margins in order to accelerate high profit service sales.

When utilized effectively, compensation is an effective tool for managing channel conflict if firms pay partners that add value on behalf of a line and do not pay those, adding little or none. Compensation must be structured carefully as the wrong type can actually worsen conflict–for example, when a supplier with a leading market share causes channel stuffing by using order quantity discounts.

Suppliers must coordinate their strategy and compensation. A supplier with too many (or the wrong



type of) partners may end up using extra discounts and rebates to manage its own conflict. This is an expensive strategy and is a sure way to erode profitability.

How Much To Pay?

Suppliers continually question the deals they offer channel partners. "Are the discounts too deep?" "Can or should we cut rebates?" "What will happen if we raise price?"

An important first step in determining how much to pay a channel is to identify the "Target Street Price" (TSP)–the price a supplier needs to win or maintain the business with the end user. The TSP is based on the value of the supplier's offering relative to the competition. This is also the price that should be the starting point for channel discounts, rebates and other forms of compensation.

Once the TSP is identified, the supplier can examine the following factors in order to determine appropriate compensation levels:

Competition. A good starting point is to learn how your competitors structure their compensation programs. You want to know how much they pay.

Market Power. A supplier with a strong brand can pay less for the same performance as a supplier with a weaker one. To understand this, consider the discussion above as to why resellers, or other channels, sell what they do.

Cost of Performance. You need to determine what you expect channel partners to do in exchange for the compensation they earn. If it costs a distributor 25% to sell to small customers, then you will have a hard time motivating them with 15%. **Cost however, is not the total picture. A supplier with a very strong brand can motivate a partner to perform distribution functions while paying less than their expense. In this case, weaker brands end up subsidizing the channel's cost. This is actually one of the key benefits of a strong brand.**

Switching Costs. Channel partners often make large investments in a supplier's line. These investments include physical inventory and years of accumulated support. Suppliers should understand their channels' switching costs in order to determine the amount of compensation to pay.

A value supplier may want to encourage certain behaviors by its partners by

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paying for them. For example, a supplier may target a certain vertical market and provide deeper discounts or bigger rebates on sales into that space.

What to Pay For?

A discount off of list price carries an expectation that a channel will perform certain functions in exchange for that discount–such as to sell, inventory, market and support the supplier's line.

There are cases, however, when a firm does not need its distributors to perform all of these tasks. If a supplier has a direct sales force that generates demand in the market and fulfills through distribution, then the supplier does not need to pay the channel to sell. Likewise, a company does not need to compensate a distributor for carrying inventory when most sales are drop-shipped.

Channel partners are motivated by margin. Suppliers should watch the increase in days outstanding when they change payment terms from 2% 10 days to Net 30. Compensation can influence the way channels buy, inventory, sell or support products or services.

Is spending 1% in market development a better investment than using those funds to hire more sales representatives? Bottom line: you want to allocate resources in the most cost effective way to drive results.

Typically, incentives built into a channel compensation system range from 0.5% to 3% for each activity. These incentives are often stacked so that programs can place as much as 5% to 15% or more at risk. These programs motivate behavior and help manage conflict by creating separation between channel members.

There are two places to look when considering how to motivate helpful behaviors through your channel compensation system. First, determine what end customers value. If, for example, they value local inventory, then a supplier can pay its partners to stock product in the field.

Second, look at your own values. If you prefer channel partners which provide point-of-sale information, or sell into selected vertical markets, then you can pay for those behaviors.

Suppliers need to weigh carefully how they deploy their resources according to their values. For example, is spending 1% in market development a better investment than using those funds to hire more sales representatives? Bottom line: you want to allocate resources in the most cost effective way to drive results.

How to Structure the Pay?

The last question is how to arrange a compensation program to include the right mix of discounts, rebates and allowances—in the right order. This part of the process offers the highest potential for creativity and differentiation.

Since a key goal of the system is to motivate behavior, an effective compensation system matches the form of payment with the structure and unique characteristics of the channel.

To determine the optimal compensation structure, one must identify degrees of influence in the channel. Two key groups are involved—management and sales. Management usually prefers incremental rebates over discounts since they can be hidden from the sales force and used to fund pet programs and to pad profitability. When the supplier provides rebates, however, it typically keeps prices higher or reduces discounts in order to cover the rebate cost.

How channels account for rebates is another important consideration relative to program structure. Rebates do not always make it to their intended target. Even if distributors allocate rebates to individual branches, they may lump them in with those from other suppliers and so diminish their impact.

Suppliers must also consider how partners deploy different types of compensation. Distributors can use rebates like cash. They can choose to invest this money in the supplier's brand or conversely use it to support competing lines. Many partners simply choose to take rebate dollars out of the business.

In contrast, marketing allowances or funds can be utilized to pay for specific activities that require an investment by the channel partner on the supplier's behalf. Firms should consider all of these points when assessing how to compensate their partners.

Summary

Various factors contribute to the development of an optimal channel compensation system. Many suppliers simply tweak their current programs or play "follow the leader" due to the complexity of these factors.

By carefully considering the four key questions discussed above (whom to pay; how much to pay; what to pay for; and, how to structure the pay), suppliers can fundamentally alter the playing field in ways that significantly accelerate their profit and growth.