How to Pay the Executive Who Powers Your Sales and Growth

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Gallagher

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Compensating salespeople in smaller and startup companies — where the founder or senior executives often drive sales — can be tricky. How do you attract and retain talent while managing costs and aligning incentives with company growth? A compensation cost of sales analysis offers a useful framework.

A well-designed sales incentive plan ideally motivates and rewards effective sales efforts. Sales compensation includes salary — typically calculated as annual pay — and financial incentives like sales commissions and quota bonuses for salespeople reaching targets.

But how can sales leaders design incentive plans to apply to smaller or startup companies where senior executives generate the sales instead of a salesforce? Such organizations must determine appropriate incentives to build a fair and competitive cost structure to pay a salesperson who is also the founder or CEO.

Paying the sales “hunter” and the “farmer”

An effective sales compensation plan encourages positive behaviors, sets expectations and standards for compensation, and drives results to achieve team and organizational goals. The optimal sales compensation program distinguishes between the sales “hunter” and the “farmer.” Hunters focus on acquiring new accounts and typically draw lower base salaries enhanced by volume-based commissions for successful sales efforts. Those in farmer roles focus more on long-term client relationships and less on immediate sales. These sales professionals typically earn a higher base salary combined with a smaller quota bonus.

MEASURING THE COST OF SALES

All organizations, whether they directly employ a sales team or indirectly hire dealers or agents, incur sales compensation costs. The compensation cost of sales (CCOS) represents the sum of the various forms of rewards for achieving revenue goals. Leaders can use this hypothetical pool of money as sales commissions and incentives, reinvest it for growth, or enhance price competition to boost market share.

We define CCOS as a percentage:

Annual total cash compensation (base salaries and incentives paid but not benefits or other costs/expenses)

Divided by total annual sales revenue

For example, a company with a higher cost of sales compared to a direct competitor with related products and a go-to-market strategy would suffer a competitive disadvantage. Surprisingly, industry is not a significant factor in determining the market CCOS. However, a company selling at a higher price point due to superior marketing or perceived higher product quality may calculate a higher CCOS percentage, resulting in higher profitability.

DEVELOPING A CCOS FRAMEWORK TO ASSESS SALES EFFECTIVENESS

At Gallagher, we use sales CCOS and comparisons to understand the cost structure of a sales organization. We diagnose whether the cost is industry competitive and supports the organization's strategy. To create a baseline for comparison with individual organizations, we gathered aggregate data:

- Identify actual total cash compensation and sales revenue data from client projects over the previous 10 years. This includes 40 to 50 sales organizations of multiple sizes from various industries.
- Collect associated information, including industry, total revenue (size), margin percent, year-over-year growth history, typical deal size, typical account size, direct versus indirect sales channel mix, number/complexity of roles and number of sales employees. We summarize and conduct regression analyses to determine which factors wield the most effect on CCOS.

- Drop those factors without meaningful or conclusive correlation with CCOS.
- Determine how the meaningful factors explain how the CCOS percentage would vary based on a company's fit within the selected parameters.

SALES CCOS FRAMEWORK RESULTS

Based on our analysis, **most companies' CCOS ranged from 2% to 12%,** helping to determine whether the cost of sales aligned with comparable companies. (This framework may evolve over time based on new data and experience.)

Six parameters comprised the framework*:

1. Company size (<$100M to >$100B)
2. Gross margin (<20% to >80%)
3. Growth expectations (-0% to >25%)
4. Typical annual customer size (-$10K to >$25M)
5. Typical size of sale/deal (-$1K to >$10M)
6. Indirect/direct sales channel mix (100/0 to 0/100)

Every organization operates with an implicit or explicit CCOS, even if the company does not pay sales commissions or employ a sales force. As consultants, we compare the sales organization's actual financial situation for each of the six framework parameters, take the average and apply it to the range of 2% to 12% in the framework above.

This calculation is not a final determination, but a sign of whether the CCOS appears as expected. If a company's CCOS percent falls outside of the norm, additional review may warrant a change in methodology. Further examination may include data analysis to re-evaluate the sales incentive structure.

Compensation Cost of Sales Continuum

<2% CCOS Continuum >12%

CCOS Drivers	CCOS Norms for Key Business Drivers				
Company Size	>$100B	100B–10B	10B–1B	1B–100M	<$100M
Gross Margin	<20%	20%–40%	40%–60%	60%–80%	>80%
Growth Strategy	<0%	0%–8%	8%–16%	16%–25%	>25%
Customer Account Size	>$25M	25M–10M	10M–1M	1M–10K	<$10K
Size of Sale (Typical)	>$10M	10M–1M	1M–100K	100K–1K	<$1K
Indirect/Direct Sales Mix	100/0	75/25	50/50	25/75	0/100

*Industry was not a significant factor in calculating CCOS.

EXAMPLE SALES CCOS APPLIED TO A SMALL BUSINESS

CCOS analysis applies to multiple situations. For example, CCOS may help evaluate compensation paid to senior executives who drive sales. Using CCOS as part of a pay analysis, we reviewed senior executives for a small privately held business over a 2 year period.

Analysis shows that a typical CCOS would fall in the 7% to 8% range, as illustrated below:

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Customer Account Size	>$25M	25M–10M	10M–1M	1M–10K	<$10K
Size of Sale (Typical)	>$10M	10M–1M	1M–100K	100K–1K	<$1K
Indirect/Direct Sales Mix	100/0	75/25	50/50	25/75	0/100

= Approximate client designations

- Total compensation CCOS for the sales-focused executives: 4.5%
- The framework indicates conservative pay for the 2 years studied compared to benchmarked companies.
- The 4.5% included equity pay, further substantiating the conservative pay level.

HOW TO PAY THE CEO "SALES WARRIOR"

A traditional method of determining market compensation combines a peer group of companies with survey data, such as from Gallagher's CEO and Executive Compensation Trends report to determine appropriate compensation. However, CCOS can help determine the market pay level for a CEO who sells and closes significant revenue. Paying top executives or the "CEO Sales Warrior" (CEOSW), common in emerging companies, requires a carefully crafted compensation package to reflect the leader's unique roles and contributions. Steps include:

1. Use the CCOS analysis to determine the market level of incentive associated with the revenue level, using survey data and comparable companies.
2. Figure in the sales channels and contributions.
3. Determine the CEOSW's contribution.

This calculation could serve as a resource to determine how much more the business may have to pay should the company install a salesforce, or if the revenue generation shifted away from the CEOSW. The CCOS percentage will determine an appropriate level of compensation for the level of revenue. In conjunction with a traditional market study, the CCOS approach can guide compensation for the CEOSW.

When a CEO sales warrior is also a founder holding significant equity, an effective compensation package must balance immediate performance incentives with long-term rewards. A similar conundrum emerges when a founder who owns 25 percent or more of the company steps aside. The company must pay market rates to the new CEO, who likely holds little or no equity, as in the case of an internal promotion.

The framework below guides compensation for the CEOSW's unique role:

Key Considerations

1. Dual role compensation

- Base salary: Ensure the base salary reflects the leadership responsibilities as well as the direct sales contributions.
- Sales incentives: Design incentives that reward sales performance, reflecting the CEO's sales contribution to the company's revenue.

2. Equity compensation

- Existing equity: Acknowledge the founder's significant equity stake, which already provides a substantial incentive. Additional equity awards may reflect the company's performance and milestones. For a founder, equity considerations may include:
  - » Equity may be owned/bought and not awarded in connection with regular equity awards, and
  - » The founder could step aside and let someone else run the company, which may not support shareholder value.
- Equity grants: Offer new executives competitive equity packages to align with the company's long-term success. This approach may differ from the founder's existing equity structure.

3. Profit and revenue sharing

- Revenue sharing: Provide a percentage of revenue or profit directly tied to the CEO's sales contributions. This keeps the compensation aligned with the leader's impact on the company's financial performance.
- Profit sharing: Offer a share of company profits to link compensation with overall business success.

4. Long-term incentives

- Retention bonuses: Implement bonuses tied to key growth phases to retain the CEO through critical periods.
- Performance milestones: Set milestones for significant achievements (hitting revenue targets, securing major contracts) that trigger more rewards.

5. Succession and transition planning

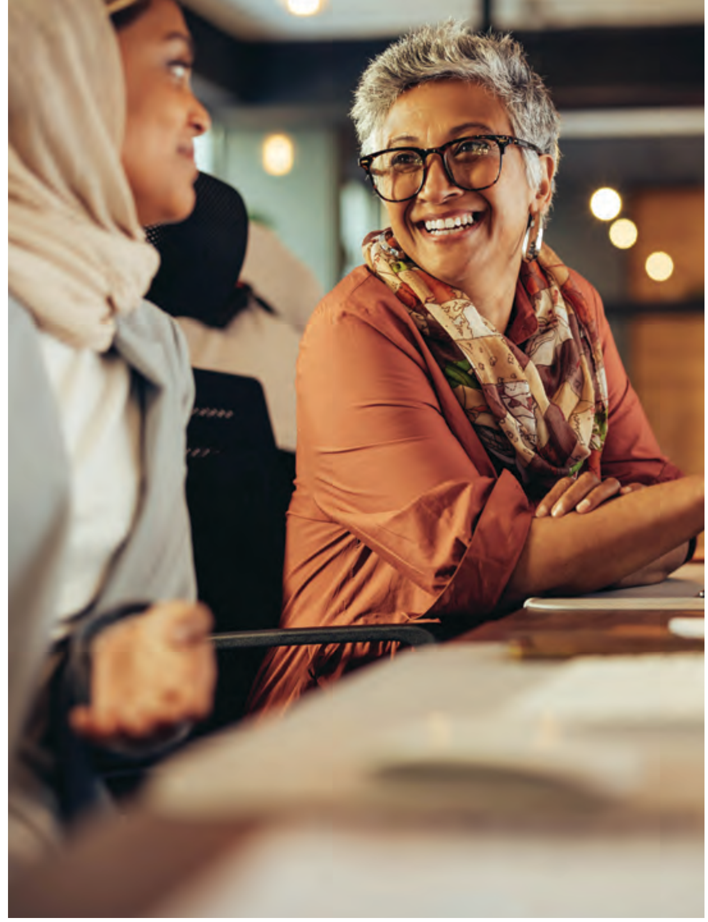
- Succession strategy: Develop a plan for leadership transition, including preparing internal candidates or attracting external talent. Such preparation ensures continuity and readiness for when the founder/CEO steps down or shifts focus.
- Market-competitive package: Ensure that any future CEO, whether an internal promotion or external hire, receives compensation that reflects market rates and accounts for the lack of significant equity compared to the founder.

MIGRATION FROM START-UP/GROWTH PHASES: COST OF SALES VERSUS COST OF LABOR

While careful analysis of the cost of sales is important, this analysis varies as the organization grows. When companies move through their high-growth phases, organizations base sales rep pay (or executive pay if they serve as the initial market share drivers) on what the company can afford during startup. Early salespeople may earn very high pay if the finance team determines that the pay fits profitability calculations.

As the company gains market share and annuity client relationships, the organization creates new business development roles such as account manager — which evolves the CCOS assumptions as well. At this stage, companies transition to paying salespeople market wages given the organization's roles, headcount and sales quotas.

Such a shift does not mitigate the importance of measuring CCOS, however. Sales leaders must monitor CCOS for a maturing salesforce to understand whether costs are growing in accordance with the associated revenue growth, and how those costs compare to the competition.



The framework below shows how sales pay methods, account assignment and sales crediting evolve as companies mature:

1 START-UP	2 HIGH GROWTH	3 OPTIMIZATION	4 MATURITY
Characteristics: Commissions High Risk Simple Territories Solo Credit	**Characteristics:** Commissions Moderate Risk Split Territories Split Credit	**Characteristics:** Quota/Bonus Moderate Risk Accounts/Territories Multiple Credit	**Characteristics:** Quota/Bonus Lower Risk Accounts/Segments Team Credit
$0–$100M **30% to 50% CAGR**	**$100M–$1B** **20% to 40% CAGR**	**$1B–$5B** **10% to 20% CAGR**	**$5B-plus** **-10% to 10% CAGR**

The CEOSW role can be critical in the start-up and high-growth phases, but is typically replaced/phased out by the optimization phase as a solo sales driver is not sustainable.

USE CCOS TO GUIDE SALES COMPENSATION FOR EXECUTIVES

A compensation cost of sales (CCOS) analysis offers start-ups and smaller organizations a framework to measure total compensation levels, including equity, in situations where the traditional cost-of-labor pay philosophy may not yet apply. Further, the CCOS framework helps to validate compensation levels for CEOs or other top executives who serve as sales warriors.

Savvy sales leaders can use CCOS to assess whether their salesforce's coverage model aligns with the company's financial objectives. Since there is no standard optimal CCOS percentage, actual company results can help indicate whether individual CCOS levels are higher or lower than they should be in the organization's market position.

GALLAGHER CAN HELP

Gallagher uses data, technology and trust to design and evaluate sales compensation models to fit your company's strategic goals. We can calculate the compensation cost of sales tailored to help your organization determine compensation for executives who also deliver significant sales revenue.

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