

# SALES & MARKETING MANAGEMENT

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Service: Is It  
Worth the Effort?

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# SERVICE

## IS IT WORTH THE EFFORT?

Is your sales force spending its time as efficiently as it can? Here's a formula for finding out.

BY RICHARD W. HELFRICH

Productivity is a hot topic these days, and statistics show that manufacturing productivity has improved consistently for several years now.

Service productivity, on the other hand, has not.

In many industries, sales practices—and sales support practices in particular—haven't advanced in decades. Basically, a salesperson still makes calls, gives a pitch, and entertains the customer. But there's more—sometimes a lot more. He might call for help from the factory and have a company expert visit the prospective customer. When he gets a tentative agreement, he contacts the home office to confirm price and delivery terms. When the agreement is finally made, he then fills out a company order form and faxes it to a sales office where it's entered into a computer.

And what about after the sale? Additional support might be required from either factory-based or regionally based field experts. Local sales offices will be called upon to provide follow-up on on-time delivery, tracking any changes in quantities on a weekly basis to meet the customer's requirements. And complex tracking systems in the factory or home office try to keep up with all these changes, making sure that everything goes smoothly until the order is shipped.

Of course, all this service costs—and costs big. In the electronics industry, for example, the cost of direct labor in producing integrated circuits has declined to a mere 7% of the total

cost of delivering the product. The cost of sales and support, however, is several times that amount. The problem is, the convoluted accounting systems employed by many companies make it increasingly difficult to pinpoint all the various costs of serving the customer, and because of this, little effort is made to improve this all-important aspect of selling.

Still, where there's a will, there's a way. By taking into account all the relevant factors included in service—and their respective costs—management can improve productivity by allocating these service "resources" in a way that's consistent with solid market opportunities—to say nothing of profitability.

Of course, some sales managers will claim they already do this. From my experience and the experience of other consultants in similar roles, however, it's clear that these efforts are based on either incomplete information or 'gut feel.' What's really needed is a system by which sales and marketing managers can bring quantitative analysis techniques to the service productivity issue.

But how do we go about setting up such a system? First, some basic questions need to be answered: How cost-effectively is your company using various service techniques like pre- and post-sales support, different channels of sales, and other aspects unique to your business and your customers? How well do your salespeople deal with the type of customers in your industry, based on the salesperson's education, training,





and personality type? How cost-effectively do you serve each customer? And finally: Are you serving the right list of customers?

To answer these questions, you'll need to conduct a quantitative analysis of the cost of serving your customers (and potential customers). This analysis will allow you to produce a "cost-to-serve" figure that can then be used to modify your sales and service system and reduce your companywide cost-to-serve ratio.

#### **A DRAIN ON PRODUCTIVITY**

Many factors (including revenue-based commissions) entice salespeople and management to provide sales coverage to a large number of customers. Once a customer has been added to this list, however, it goes against human nature to reduce that coverage. As a result, many salespeople spend more time than is necessary with certain accounts in order to achieve the measure of success demanded by management. Consequently, these same salespeople aren't spending enough time with the *right* accounts and performing the *right* activities.

Furthermore, changes in the marketplace—things like mergers and acquisitions, global competition, and rapidly changing technology—only compound the problem, putting increased pressure on the sales force to improve its sales per salesperson. In some cases, sales training has been stepped up; in others, management has determined that higher caliber individuals are the answer. ▶

But while these approaches may produce marginal improvements in sales per salesperson, in many cases they also reduce profitability. This is because salespeople under pressure for revenue targets will often go after marginal business at prices that are unacceptable.

Obviously, a new approach to managing the sales process is needed—one that's relatively simple to analyze yet can be utilized by both individual salespeople and management. The goal is to change the basic pattern of behavior and produce gains in productivity and profitability. Keep in mind, however, that this program must be driven by the marketplace—not by tradition.

This new approach to the sales process—the cost-to-serve approach—must take into account several factors. For example: The traditional goal of any sales force is to maximize revenue. With the cost-to-serve approach, however, it's essential to balance the needs of current revenue, revenue growth, and profits. Also, a salesperson has very little impact on real profits, except in getting the highest price practical in the marketplace. The salesperson has no direct impact on gross margins, research and development, or general and accounting overhead.

On the other hand, a salesperson generally has direct control over the selling expenditures directed at his or her customers, which allows you to look at the efficiency of the salesperson on a customer-by-customer basis. This "efficiency quotient" can be calculated as the percent of revenue for an individual customer that's spent on the *entire* sales/service process—the scope of cost-to-serve being much larger than the traditional cost-of-sale.

Based on the current and projected cost-to-serve percentages calculated for each of the customer accounts served by a company, a number of decisions can be made. These include determining how much sales resource to apply to each account, the right mix of sales channels to utilize at that account, and the location and number of sales personnel needed to optimize the revenue growth and profits of the company. In addition, it also becomes possible to develop an improved incentive plan that better matches the goals of the salesperson to those of the company.

#### SERVING UP THE NUMBERS

To measure the cost-to-serve, both the *costs* and *revenues* of individual customer accounts must be determined. Revenue is often the easiest to ascertain, since commissions are usually

## Calculating Cost-to-Serve

Because cost-to-serve varies dramatically by industry, they're aren't any "absolute" numbers. In the electronics distribution industry, for example, even though most distributors keep approximately 25% of the sales price, they produce modest profits at best. In the pharmaceutical distribution industry, on the other hand, the distributor margins are only 6% of the sales price, but profitability (as measured by the return on assets) is far better.

To figure the numbers for your own company, use the following formula:

$$\frac{\text{A) ACCOUNT SELLING COSTS}}{\text{B) TOTAL ACCOUNT REVENUE}} = \text{C) COST-TO-SERVE}$$

A. ACCOUNT SELLING COSTS are calculated by adding the five components outlined below:

1. **Field Sales \$** = Fully loaded field sales annual rate x fraction of time on that account.
2. **Field Application \$** = Fully loaded field application annual rate X fraction of time on that account.
- 3.) **Representative Commission \$** = Commission rate x revenue base used for that account.
- 4.) **Distribution Direct \$** = Distribution % (the cost of companywide distribution organization, divided by total revenue through distribution) X OEM value of product billed through distribution for that account.
- 5.) **Incremental Distribution \$** = Incremental distribution % for that account X OEM value of product billed through distribution for that account.

based on these numbers. Costs, however, aren't quite as simple.

First, there's the cost of the salespeople themselves—including salary, benefits, and expenses. Then there are such things as management time, support, marketing, and data processing. From an analysis performed on several samples, we've determined that it's sufficiently accurate to lump all the internal marketing and sales expenses into a pool and divide by the number of field salespeople. This should be done separately for applications engineers (or their technical-support counterparts) in the field, as opposed to lumping these titles in with salespeople. Depending on the variations in costs, it may also be useful to separate expense pools into geographic regions.

The net result will be a fully loaded cost-per-salesperson-per-year figure, although this may only be a small part of the total for some companies, since most larger businesses today utilize direct sales, sales through distributors, and sales by reps. Obviously, this will involve calculating a more complex cost-to-serve ratio; a combination of the

fully loaded salesperson costs, the incremental costs of distribution, and the incremental costs of reps.

For sales through reps, for example, the cost is usually just the commissions paid to the rep for an individual account. Depending on the situation and the coverage, this percentage can vary widely. For sales through distributors, the picture is less clear. Distributors charge a substantial fee for selling, inventory, and other services. In addition, there's usually some kind of price protection and return privilege involved. Similarly, the distributor charges the customer a higher price for the ability to buy in small quantities with very quick service.

To the producer of the product, the selling cost of distribution is the net difference between the price of the product paid by the distributor and the price paid by an OEM customer. For example, if a distributor sells an item 20% higher than the producer but gets a 25% fee, the incremental margin paid by the producer is 5%. Also included in distribution costs is the cost of the distribution-support organization at the producing com-

**B. TOTAL ACCOUNT REVENUE** is calculated by adding the following three components:

1. **OEM revenue**
2. **Representative revenue**
3. **Distribution revenue adjusted for OEM pricing** = Actual distribution revenue, divided by incremental distribution margin.

**C. COST-TO-SERVE** is then calculated by dividing **TOTAL ACCOUNT REVENUE** into **ACCOUNT SELLING COSTS**.

One final note: Cost-to-serve analysis shouldn't be done in a vacuum. In addition to quantitative analysis, it's essential to interview customers and salespeople about their concerns. However, this should only be done after preparing detailed questionnaires that can verify any results of your analysis. In most cases, it's helpful to conduct some of the customer interviews in a "blind" situation, where they know the industry you represent but not the company. This may not only elicit some candid comments about your company but about your competitors.

In the salesperson interviews, a guarantee of anonymity with respect to sales management is also helpful. Concerns about organization and compensation plans will be uncovered, but only if the salesperson has no fear of reprisals. In many instances, a survey of the entire sales force is invaluable. This survey should include a detailed breakdown of each salesperson's time over the course of a week or more. Such an approach may uncover some of the reasons behind a high, companywide cost-to-serve ratio.

pany, expressed as a percent of distribution sales. From our experience, it's sufficiently accurate to use a single percentage rate for all distribution.

Putting all these costs together will yield the cost-to-serve. However, to take into account any growth opportunities in the customer base, it's important to use the current year *and* the following year when making your calculations. In each case, the total complex costs need to be calculated and then divided by total revenue (see sidebar above).

#### **WHAT DOES IT ALL MEAN?**

After the cost-to-serve has been calculated for all the significant accounts served by a company, some decisions to increase productivity can then be made. The first step is to extract certain information from the accumulated data.

One thing that's usually helpful at this point is to create graphs of the data in order to uncover trends. Plot your cost-to-serve percentage on the vertical axis of a scatter chart, with the annual customer revenue on the horizontal

axis. A real-world example from the electronics industry is shown in the chart on page 50.

In our experience, these kinds of charts and graphs usually expose a trend or two. In this case, a \$100,000 account costs half the percent effort to service as a \$10,000 account—and the \$1 million account is half the \$100,000 account. This tells you that at a certain revenue threshold, the cost-to-serve becomes constant. Almost all accounts above this level have roughly the same cost-to-serve. Likewise, at a low revenue level—and depending on the type of business (average selling price per unit, number of purchase orders per year per customer, etc.)—you will find that the cost-to-serve will exceed 100% for most accounts.

A high cost-to-serve for small accounts indicates that too much salesperson time is being spent at small accounts that haven't shown the growth necessary to justify the resources applied. Correcting the situation requires that management redeploy the sales resources consistent with current year cost-to-serve data,

with an eye toward the following year's cost-to-serve figure.

Another useful approach is to look at "net margin" by account. In this case, uncovering net margin means examining actual sales data to find a value that's close to real pre-tax profit by customer. Starting with the actual price for each product and subtracting the actual cost—as well as general and accounting overhead (G&A), R&D, and the cost-to-serve for that customer—the net margin for each product for each customer can then be determined.

Again, these results can be plotted in a number of ways: Net margin can be plotted against account size to determine if certain trends exist. In addition, other valuable trends can be spotted if net margin is plotted by geographic region, line of business, sales office, or other dimensions.

#### **TAKING AIM AT PRODUCTIVITY**

The final step is perhaps the toughest: to achieve the maximum productivity improvement possible after analyzing the data. Here, each salesperson's accounts must be examined individually, and those with high cost-to-serve ratios must be justified on the basis of return on investment.

At one electronics company, salespeople were asked to make a list of low cost-to-serve accounts and accounts that would become low cost-to-serve within six months. Each salesperson generated a list with a few names on it.

Then each salesperson submitted a list of three to seven target accounts. The combined list of target accounts had several hundred names on it and was three times as long as the low cost-to-serve customer lists put together. After examining the market situation and the financial statements of the target companies, it was clear that all but about a dozen should be cut from the target list. The rest were long shots—hundreds of customers who had little chance of ever becoming major accounts. From this we determined that if salespeople were each allowed to pick their long-shot accounts, cost-to-serve would fail to produce the desired results.

From our experience, high cost-to-serve accounts are rarely profitable—less than 1 in 20 ever achieves the size needed to justify the sales effort. Therefore, management should carefully choose a few accounts companywide (5 to 20) as growth targets. The remaining high cost-to-serve accounts should have sales resources reduced—or removed entirely.

Likewise, it's also possible that you're underallocating your resources on

medium and large accounts. Companies can usually use salespeople freed from high cost-to-serve accounts to service midsized to large accounts more cost-effectively and generate increased revenue. Unfortunately, this reassignment frequently requires relocating salespeople, closing sales offices, and shifting accounts among sales channels (OEM, distribution, and reps). This is a necessary tactic if you're going to optimize the three goals of current revenue, revenue growth, and profit (net margin).

#### LOOKING AT CASES

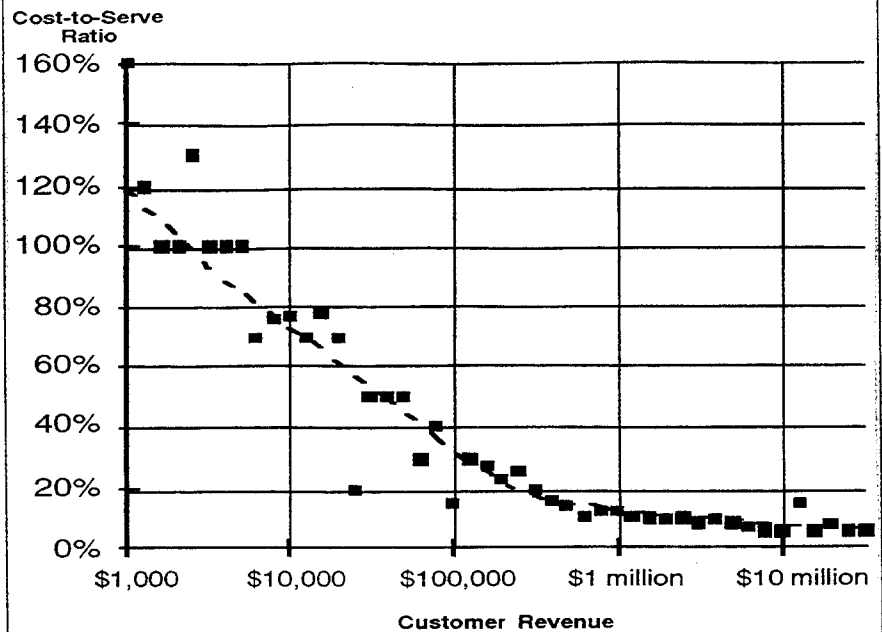
In order to provide a better understanding of what to expect from a successful cost-to-serve project, a few examples may be helpful. As you'll see, a lot of these tactics aren't particularly new or earthshaking, but what's significant is that the action was taken after a cost-to-serve analysis indicated it was needed, while prior to the analysis sales management felt none of these actions were required.

■ **Case 1: Sales office-to-rep conversion.** In a couple of regional sales offices, the overall cost-to-serve was out of line with the rest of the company. There were a few good customers in the region, but the total sales volume didn't justify a sales office. Salespeople were driving long distances and spending substantial time in their cars trying to generate additional business. Although the salespeople were top-notch, they didn't want to be relocated.

In this instance, the company financed the local salespeople to set up a rep company. This new company picked up some complementary product lines from other manufacturers in related businesses. As a result, they were able to concentrate on the few good customers in their area and increase their total revenue from their multiple product lines. The revenue to their former employer continued, while his cost-to-serve decreased. In addition, each salesperson's personal income increased substantially. This was a definite win-win situation.

■ **Case 2: Worldwide account teams.** Here, a combination of cost-to-serve analysis and customer interviews led to some changes in account coverage. It was determined that although cost-to-serve values were good or very good in some instances, revenue growth at these accounts didn't match the growth their customers were achieving in their own markets. On closer examination, it became clear that the reason was a compensation plan based on regional results. These large customers had become "global enterprises" that performed

## A Cost-to-Serve Trend Line



product development in many regional locations, vendor qualification in other locations, and purchasing in a few geographic bases.

These global enterprises required a team approach to the sales process. Also, a team approach to the commission plan was established, where each salesperson's commission depended on the sales of the entire team. In some locations, it was useful to have a salesperson be a "half-time" member of two different teams. These changes were instituted with very positive results after an initial nine-month transition period.

■ **Case 3: Non-commission plan.** In one sales office, both the cost-to-serve and the number of accounts were exceedingly high. After analyzing the market, it became clear that there were only a few good potential customers in the area. Customer interviews indicated that there was potential for a strong sales base, but the time interval was over a year. A projected cost-to-serve analysis indicated that in a few years there was a high probability that the sales office could achieve a good cost-to-serve ratio. However, the salespeople involved wouldn't be motivated to achieve these goals if they continued to be paid on a quarterly sales commission plan.

In this case, it was determined that a non-commission "management by objective" (MBO) plan would be more effective. The salespeople were given quarterly objectives for each target customer. These objectives were then used to measure progress toward a future sales base.

Still, some of the salespeople were uncomfortable with this approach and wanted to stick with the original commission structure. A trade of salespeople was arranged with another sales office in order to get the salespeople with the strong commission orientation at the right location.

Keep in mind that most salespeople will determine on their own—or with the aid of management—that a new, shorter list of customers is in their best interest. It should be made clear that they can maximize both their own performance and commissions *and* the company's profitability by focusing their efforts on either a few "golden" accounts or on accounts that have a reasonable probability of becoming golden in the not-too-distant future.

Using both cost-to-serve analysis as a tool for uncovering less-than-ideal economic situations and common sense in presenting alternative solutions can be a win-win arrangement for all involved.

The concept is simple: Pick the right products to sell to the right customer through the right channel using the right price structure. Remember: The hardest part is stopping your salespeople and supervisors from continuously saying "yes" to customers when they demand sales and service resources when it makes more sense to simply say "no." □

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