Partners In Profits Or Adversaries?

How Some Manufacturers Destroy Bottom Lines With Short-Term Thinking

by JOE MILLER

The business press has commented regularly about the quarterly earnings, short-term management philosophy of U.S. companies versus the longer term and strategic approach of public concerns in other countries. Fortunately, many companies that use reps take the more strategic approach, which includes treating their outsourced sales force as partners.

We heard from a couple of MANA rep firm members recently that their manufacturers decided to arbitrarily change the terms of the representation agreement. In one case, the proposed contract revision was to change commissions from a percentage of the net sales price to a percentage of the manufacturer's "profit."

The other case involved a principal that had raised prices substantially in the past year and felt that the reps were getting a windfall because of the price increases. Thus, the reps were asked to cut their compensation back to something that approached the absolute dollars earned before the price increases. No thought was given to the fact that the reps had experienced unusual increases in employee health care premiums and gasoline prices in the same time frame.

Both decisions were shortsighted and devastating to the relationship between principals and their outsourced sales partners, and may not have even improved profits in the current quarter. Let me explain why.

Trust Is the Issue

Arbitrary commission changes or any other attempt to unilaterally change the contract with an outsourced sales force is a great way for a manufacturer to destroy trust and turn off the entire sales team. This is also true if the manufacturer takes this action with direct salespeople, but the consequences are much more serious with a rep sales force. Direct salespeople with benefits, company cars and sometimes base salaries are much more tolerant of this style of management.

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Reps may not complain too loud initially, but most professionals will mark such a principal for replacement down the road as soon as they can find a way to replace the reduced income stream proposed under the new plan. In the meantime, the manufacturer loses mind share and sales mysteriously trail off as the reps focus their time and devotion on more rep-friendly lines.

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the end of the relationship is in sight. Worse, the word spreads throughout the industry so that the manufacturer has no choice but to go direct after the existing reps eventually resign, or settle for replacement "discount" reps who are not as conscientious about protecting the manufacturer's price and margins.

Discount reps may emulate the 20th century image of the rep that just waits for opportunities to appear rather than focusing on a territory plan that creates demand for the principal's products. Direct salespeople require a fixed cost investment of over $150,000 per year. So, the two alternatives to losing the best reps due to trust issues are not good. High-performance, professional rep firms won't consider representing a line with a company that has a reputation for making unilateral contract changes.

Manufacturers Respond to Intense Global Competition

This comment will probably upset a number of associate members, but if the shoe fits, wear it. Global competition has indeed put terrific pressure on margins. The bulk of U.S. manufacturers have done an excellent job of improving productivity and bringing out new products that are the lifeblood of any manufacturing company. Others have invested substantial time and money in building strong brands.

Some manufacturers have pursued a cash cow philosophy, making minimal investments in new products and process improvements, and they are on the brink of extinction as a result. These manufacturers tend to be the same organizations that want to clip a couple of points off of their rep's commissions. They see this as an easy way to cut cost by reducing commissions with the stroke of a pen.

Even if their reps put up with it for a while, these firms are doomed to failure because of a management philosophy and a mindset that is self-destructive. If a professional rep firm sees one of its principals operating with this short-term attitude, it will immediately start shopping for a new line.

The Profit-Based Commission Myth

A minority of misguided manufacturers think a rep will do a better job selling for them if their rate of commission is predicated on the profits generated on an order. Payment based on manufacturing profitability is a poor idea from an accounting standpoint for both parties.

"Profits" can be a moving target in today's manufacturing environment. Do we mean gross profit, net profit after taxes, gross margin or contribution margin? Does profit on an order go up when the manufacturer absorbs all of his fixed costs across the volume booked in the first 10 months of the fiscal year, or does the positive variance stay hidden from the reps? Do we calculate profit based on the target gross profit in the estimate, or the standard cost system, or the way the order actually runs in the shop that month? What a nightmare!

Why not just continue to pay on net sales value as manufacturers have done for years? This precludes the need for the principal to open his books and minimizes the time the rep spends calculating commissions and cash flow. Time in front of the customer is maximized! Are unique compensation systems being experimented with today? Sure. Do they include profit-based commission rates? Only rarely, and then in very specific and well-defined ways.

Most professional reps do try to maximize the profitability of their principals, but they don't control manufacturing costs or the accounting department. They can't control the cost structure of the manufacturer and should not be penalized for losses. Reps don't get paid when an order is lost be-

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ABOUT THE AUTHOR:

Joe Miller is MANA's president/CEO. He has over 30 years of manufacturing and sales agency management experience, including general management experience with divisions of Fortune 500 companies as well as ownership of a successful sales agency selling process equipment and piping systems to energy-related markets. Joe most enjoys counseling with MANA members, agents and manufacturers alike, on the diverse challenges they face in today's market.

cause the manufacturer cannot meet the customer's required delivery. It's a risk they take. They should not be penalized when the manufacturer, who makes the pricing decisions 100% of the time, has a bad year, or takes an order that turns out to be a loser.

While a percent-of-profit approach to commissions appears to be in line with the age-old MANA Partners in Profits (PIP) philosophy, it is not. PIP does not mean that both parties to the contract share their bottom lines with each other. It ***does*** mean the rep and manufacturer care and help to protect the other partner's profitability. Manufacturers who care about the long-term profitability of their outsourced sales partners don't attempt to make unilateral commission changes, and those that do are marked for elimination. (The same is also true for reps who are unconcerned about the principal's profitability.)

Can We Solve the Problem Together?

One of the reasons we favor ongoing rep councils is that these trust issues tend to be minimized when the reps and manufacturers meet regularly to try to help solve each other's problems. If a manufacturer has a problem with margins, wouldn't it be better to summon the rep council and see if there are alternatives to arbitrary commission cuts? If we were able to raise prices substantially to pass through increased costs, but could not load our normal or better margin into the new price, could we have raised prices another couple of percentage points? If we were able to maintain margins on the increased pricing structure, why would we begrudge the same increase to our outsourced sales partners who also have rapidly escalating costs?

I have seen members of rep councils — even ad hoc councils formed to solve a one-time problem — help the principal to reduce costs just based on the reps' industry knowledge. I personally had a rep suggest a supplier of raw materials that substantially cut our material costs in a manufacturing company I once ran.

The point is this: Treat your reps as partners — plan to thrive and grow. Treat them as chattels and attempt to make unilateral changes to the contract — plan to fail. Be innovative with new products, build your brand and invest in process improvements, and succeed. Milk the cash out of the company and plan to pay the piper before too long. Often the principal who makes both mistakes is one and the same. ❒

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One Spectrum Pointe, Suite 150, Lake Forest, CA 92630-2283 • Phone: (949) 859-4040 • Toll-free: (877) 626-2776 • Fax: (949) 855-2973
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