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Sales Compensation in a SaaS Environment: A Practical Approach

by Jeff Saling, Callidus and Rick Chapman, Softletter

Executives at SaaS companies face interesting challenges when putting together effective sales compensation programs. The compensation model for licensed software companies was established almost 50 years ago in the industry and has remained fairly stable over this time. Stripped to its simplest format, the formula for licensed software sales can be expressed colloquially as $50k/ $1m/5%/$1m/$100k/50%. In other words, the "median" software sales representative expects to receive a base of $50k, sell $1m of software per annum, receive a commission of 5% on these sales and earn an annual salary of $100k, with 50% of their income coming from their base pay and 50% from commissions or "variable" income.

The above numbers are of course idealized medians and can and do change considerably from company to company and within market sectors. They are also altered by a whole panoply of other factors, including:

- *SPIFs.*
- *Accelerators (normally, increases in commission percentages based on exceptional or targeted sales performance).*
- *Overrides (a variant of the above).*
- *Non-cash based compensation such as car leases, trips, dinners, etc.*

Typically, commissions are paid in licensed sales on what is normally called the TCV (total contract value). Other acronyms include LTV (lifetime value) and TLV (total lifetime value). In an idealized sales situation, a representative who has sold $100k of software licenses will receive a 5% commission on $5k of the sale. Depending on the company and the market, the sales rep may receive additional compensation on sales of professional services bundled into the deal, the maintenance package, perhaps an additional reward for selling a new or "undersold" product, and so on. But underneath all the encrustations and provisos loaded onto a sales compensation plan, the outline of the primeval $50k/ $1m/5%/$1m/$100k/50% model can always be glimpsed.

*The SaaS model presents challenges to this tried and true approach. In the on demand model, the salesperson is selling not a license but a time-limited subscription. While the **2010 Softletter SaaS Report** shows that the yearly payment option is now the most popular among SaaS firms, many*

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companies will continue to be paid in recurring chunks, most often monthly, though quarterly is becoming increasingly popular. This puts pressure on the bottom line and profitability. How do SaaS firms adapt?

One answer has come came from blogger and SaaS firm Xignite executive Joel York. On his popular blog site, Chaotic Flow, Joel recently posted an article entitled SaaS Sales Compensation Made Easy (http://chaotic-flow.com/saas-sales-compensation-made-easy/). Unfortunately, the article is not that easy to read; Joel is a self-proclaimed numbers junkie and many of his writings require you to deep dive back into your high school algebra. After some tussling with the article and Joel, I was able to extract an applied example from him on the Linked In Enterprise Software Group. You can read the exchange and comments from group members online (you'll have to join Linked In and the group first.)

We found Joel's initial model intriguing but after analyzing his applied example, unsatisfactory if you wanted your sales force to pursue multi-year deals. Joel has altered his model based on the feedback he received and has created a spreadsheet you can use to calculate your compensation rates; it's available directly from his website at this link: http://chaotic-flow.com/saas-sales-commission-calculator-for-long-term-contracts/?show=comments#comments or on the Softletter site. We warn you that we still have some issues with his approach; these are discussed further in the article below. Make up your own mind about his model and whether you'd like to adapt it as the cornerstone of your compensation plan.

With all this in mind we decided to have a talk with Jeff Saling, former senior VP of sales at Callidus, a SaaS-based firm that specializes in providing sales compensation services.

"The biggest issue I have with formula driven models such as the ARR system proposed by Joel York is that they're not 'transparent' enough. When the stated 'real' contract amounts are interpreted through a formula versus being taken at face value either in terms of ACV or TCV—either of which can have an argument made for it—sales people grow very suspicious (the best ones are paranoid to begin with) that they are being done over somehow and it impacts their performance and dedication to the task. "

—Jeff Saling
Callidus

Jeff, what are your recommended guidelines for establishing a successful SaaS sales compensation program?

In my experience, the most successful plans are very transparent to the sales force; this cuts down on compensation plan shadowing (the salesforce tracking your plan with their own, home-grown Excel spreadsheet) and dampening down the normal distrust surrounding this issue.

A transparent enterprise compensation plan will normally encompass no more than four or five of what I call "levers," incentive factors that are core parts of the plan. A good model should, in my opinion, integrate:

- A percentage over time lever (this is what the core commission is based on). As you've noted, 5% is the common median, but I've seen cases where companies offered 10% to help kickstart sales.
- An incentive program that encourages sales reps to generate revenue over time and not sandbag accounts, nor game the compensation plan.

For example, I've seen plans that based as much as a third of commission compensation on bringing in business quarterly. Of course, each business has a different business cycle. At Callidus, the third and fourth quarters were big ones, so our compensation plan needed to take this into account.

- Contests, SPIFs, president's club, car leases, etc.

- Incentives on selling highly profitable services such as professional services. Commission rates on these range from 1% to 2%, with 1.5% being the most popular median. One caveat to keep in mind is that in terms of the revenue breakdown, in licensed sales it's not at all uncommon for the revenue ratio breakdown of professional services to software licenses to reach as high as 5 to 1. But in SaaS, the ratio of professional services to subscription revenue is much narrower, with the numbers coming in at .8% to 1 to 1.25 on average (and customer resistance rises steadily as the professional services ratio approaches 1).

You can add additional levers, such as extra incentive for selling particular products, seasonal incentives, etc. But as the plan becomes more complex, the less trust the sales force will have in it and the more time they'll spend pouring over their compensation spreadsheets.

One of the biggest problems facing SaaS firms is the problem of ramping up cash flow because of the inherent nature of the recurring revenue model. How should SaaS companies deal with this?

One obvious answer is by pursing annual or multi-year deals; I believe this helps account for the high percentage of companies who rated this as their most popular subscription options in ***Softletter's*** **SaaS Report.** For a startup, you can pursue a "pay variable compensation on a cash in basis," but once you have more than three for four people in your company, this won't work well.

To help companies develop more effective compensation plans, I've developed a generic SaaS (enterprise) model. It's a starting point, but I'm confident it works well for the rep and the company that meets the assumptions—and with some slight adjustments, for those who don't. Obviously, rates and amounts need to change to fit the business. You'll note that the numbers I use don't incorporate discounts, but I think you can quickly build those in.

Speaking of discounts, what's the range you're seeing in SaaS multi-year deals?

Typically between 1.5% to 5%. But back to the plan. It's an accumulation of many different styles and practices to address situations of up to three years—and ties the rep into an account for service consistency that's much more important in SaaS than the license business.

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"The things that are hard to incent in a sales plan are the lower level terms that can kill revenue recognition (separate from cash collection). When you try to tie those in, it can become complicated for everyone (sales, customers, finance and legal). Those items need to be managed outside the plan. "

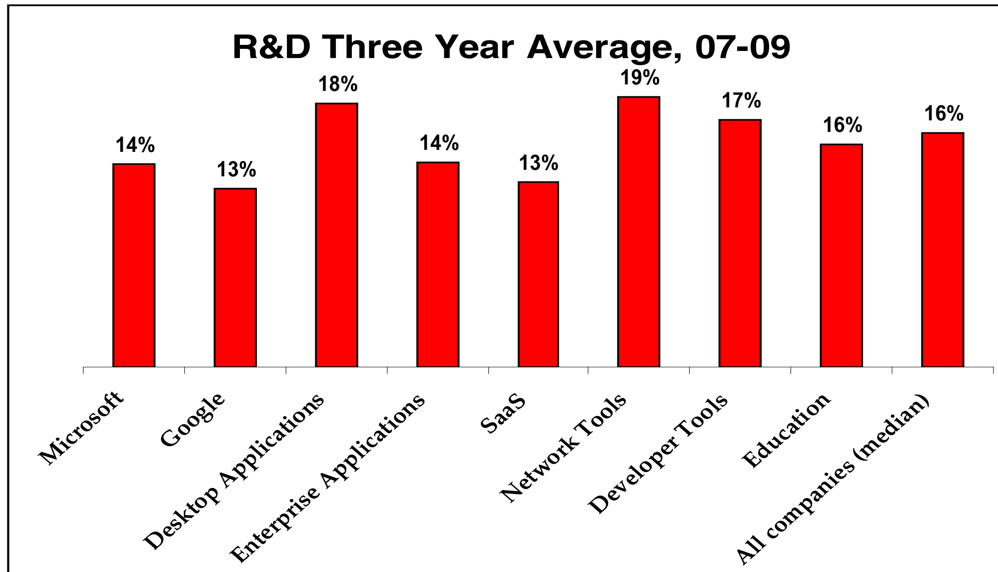
—Jeff Saling
Callidus

"Some of the same well established basic practices (with some common sense adjustments) that work well in insurance and mobile phone sales work for SaaS. "

—Jeff Saling
Callidus

"Beyond three year deals (which are very rare)—you typically "flip" to a more license type model and simply pay 5% or 6% of the TCV on that one contract, let them retire quota up to 100% as TCV instead of ACV (annual contract value)/ARR (annual recurring revenue) and put the rep on accelerators for the balance of the year. "

—Jeff Saling



Benchmarks: Research and Development, 2009

R&D expenditures are a critical benchmark for software companies and a careful analysis of these expenditures can provide interesting insights into industry trends and company triumphs (and travails). For example, virtual technologies, which underly the current Cloud craze, are hot and companies such as VMWare, who are at the forefront of the movement, are throwing development resources into their product lines in an attempt to stay competitive in this rapidly expanding market sector.

As with almost all key business operations metrics, being big helps provide attractive ratios, as our Microsoft (15%) and Google (12%) numbers illustrate. We do note the small but significant rise in Microsoft's R&D over the last three years; we attribute much of this to the resources that had to be thrown into Windows 7 development, expenditures Microsoft **had not** planned on when Vista was released in 2007.

For several years we've noted the advantage that SaaS companies (a 13% three year average) enjoy over other categories in the Benchmark 50; this year sees this advantage continue. Clearly, the SaaS development model, with its unified code base, more simplified test beds (though developers sigh every time a Safari, Chrome, and new IE and Firefox release reaches the market), and clean upgrade process (for the most part) offers significant savings in this key metric. These numbers are even more impressive when you consider that SaaS companies are releasing new capabilities and features into their products at a far higher rate than their desktop and client/server equivalents, numbers documented in our SaaS survey and ***The Softletter 2010 SaaS Report***.

Enterprise Applications also performed well in our breakdowns, but here there are a couple of caveats. As with desktop/products, companies competing in these markets are facing slower overall growth and customers who are pushing back against the 12 to 18 month traditional release cycle; while this is not a harbinger of revenue and profit growth, this trend does tend to lower R&D costs.

The Benchmark 50: Research and Development, 2009

	Revenues (000)			Res. and Dev.			Avg.
	2007	2008	2009	2007	2008	2009	'07-'09
Microsoft	**$51,122,000**	**$60,420,000**	**$58,437,000**	**14%**	**14%**	**15%**	**14%**
Google	**$16,593,986**	**$21,795,550**	**$23,650,563**	**13%**	**13%**	**12%**	**13%**
Desktop Applications				**19%**	**18%**	**18%**	**18%**
Adobe	$3,157,881	$3,579,889	$2,945,853	19%	18%	19%	19%
Corel	$250,480	$268,230	*	19%	17%	*	18%
Intuit	$2,672,947	$3,070,974	$3,182,537	18%	20%	18%	18%
Smith Micro	$73,377	$98,424	$107,279	20%	31%	34%	28%
Symantec	$5,199,366	$5,874,419	$6,150,000	0%	15%	14%	10%
Bitstream	$23,610	$24,008	$21,489	20%	22%	23%	22%
Nuance Commo. (Scansoft)	$602,000	$868,500	$950,400	13%	13%	13%	13%
Vertical Market Applications				**16%**	**18%**	**19%**	**18%**
Ansys	$385,340	$478,339	$516,885	15%	28%	27%	23%
Autodesk	$1,839,800	$2,171,900	$2,315,200	22%	23%	25%	23%
Unica	$102,243	$121,131	$100,618	22%	19%	20%	20%
Allscripts	$281,908	$383,771	$548,439	15%	10%	7%	11%
Advent	$215,303	$264,832	$259,508	17%	16%	19%	17%
Micros	$785,727	$954,184	$911,847	4%	4%	5%	4%
Enterprise Applications				**14%**	**14%**	**15%**	**14%**
Sapient	$565,989	$687,488	$666,678	21%	18%	18%	19%
SPSS	$291,000	$302,913	*	17%	14%	*	16%
Manhattan Associates	$337,401	$337,201	$246,667	14%	14%	15%	14%
Concur Technologies	$115,996	$215,491	$247,596	14%	11%	10%	12%
Pegasystems	$161,949	$211,647	$264,013	16%	15%	15%	15%
Lawson	$750,388	$851,926	$757,328	11%	10%	11%	11%
Open Text	$595,664	$725,532	$785,665	13%	15%	15%	14%
SaaS				**12%**	**13%**	**14%**	**13%**
Blackbaud	$257,038	$302,495	$309,338	11%	13%	15%	13%
Callidus	$101,657	$107,181	$81,058	15%	14%	17%	15%
Omniture	$143,127	$295,613	*	12%	13%	*	12%
salesforce.com	$497,098	$748,700	$1,076,769	9%	9%	9%	9%
RightNow Technologies	$112,077	$140,435	$152,687	15%	13%	13%	14%
Savvis	$793,833	$857,041	$874,414	28%	25%	26%	26%
Vocus	$58,076	$79,383	$84,579	7%	6%	6%	6%
Network Tools				**19%**	**20%**	**17%**	**19%**
Novell	$932,499	$956,513	$862,185	22%	20%	21%	21%
Citrix Systems	$1,391,942	$1,583,354	$1,614,088	15%	18%	17%	17%
McAfee (Network Associates)	$1,308,220	$1,600,065	$1,927,332	17%	16%	17%	16%
iPass	$191,732	$191,368	$171,377	11%	9%	8%	9%
VMWare	$1,325,811	$1,881,027	$2,023,937	22%	23%	25%	23%
NetScout	$102,472	$168,956	$267,604	29%	24%	14%	22%
Quest Software	$630,981	$735,377	$695,236	19%	21%	21%	20%
Developer Tools				**16%**	**17%**	**19%**	**17%**
Magic Software	$580,400	$620,000	$550,400	4%	3%	2%	3%
Red Hat	$400,624	$523,016	$652,572	24%	25%	23%	24%
Sybase	$1,025,530	$1,131,930	$1,170,569	15%	13%	12%	13%
Progress Software	$493,500	$515,560	$494,137	16%	17%	19%	17%
Pervasive Software	$40,783	$42,467	$47,218	24%	24%	22%	23%
TigerLogic Corp.	$18,744	$19,772	$16,252	50%	40%	47%	45%
MicroFocus	$171,600	$228,200	$274,700	13%	13%	12%	13%
Education				**17%**	**15%**	**14%**	**16%**
Apollo Group	$2,723,793	$3,140,931	$3,974,202	45%	44%	40%	43%
Renaissance Learning	$107,932	$115,223	$121,513	17%	15%	14%	15%
Scientific Learning	$46,053	$47,754	$55,288	10%	15%	12%	12%
Skillsoft	$225,172	$281,228	$328,494	18%	18%	15%	17%
Saba Software	$99,867	$107,777	$102,821	17%	15%	17%	16%
SumTotalSystems	$121,924	$126,646	*	18%	17%	*	17%
Plato Learning	$69,632	$68,401	$65,183	6%	6%	4%	5%
All companies (median)	**$314,201**	**$274,729**	**$532,662**	**16%**	**15%**	**15%**	**16%**

Note: “Years” may not correspond to company fiscal years. Individual firms are averages; segments are medians. * 2009 filings not yet available.

Sample Enterprise SaaS compensation Plan

Assumptions:

1. Average ARR (annual recurring revenue)/ ACV (annual contract value) is in the range $200,000 to $250,000

2. Quota range is $750,000 to $2,000,000, depending on sales territory (average: $1,000,000)

3. Range of "normal" ARR / ACV contracts is $50,000 to $2,000,000

4. Normal term is one year, average of all contracts signed in a year is 19-22 months

5. OTE (on target earnings) for incentive portion of pay should be $110,000 - $140,000 (+ SPIFs and contests)

    a. Commission to bonus ratio is 75/25 to 67/33

    b. Annual renewals account for 15% to 20% of total incentive compensation

SaaS Account Executive Compensation Plan

Incentive schedule #1: Commission on ARR / ACV (not TCV over X period of time)

Term / Payments	Quarterly Arrears	Annual Up front	All Up front
1 Year	5%	6%	6%
2 Years	6%	7%	8%
3 Years	7%	8%	9%

Incentive schedule #2: QQB (Quarterly Quota Bonus)

1. Account executives are paid a bonus of ($8,000) each quarter in which they compensationlete a minimum of 20% of annual quota performance.

2. Account executives who exceed 25% of pro-rated (YTD) annual quota performance in a quarter are paid forward their remaining QQB on a YTD basis @ 125%

3. If the minimum performance is not met, 50% of the QQB at risk in the quarter is forfeited. The remainder is rolled forward to the subsequent quarter, except at year end.

Incentive schedule #3: Renewals on ARR / ACV (not TCV)

Term / Payments	Quarterly Arrears	Annual Up front	All Up front
1 Year	1.5%	2%	2%
2 Years	5%	6%	7%
3 Years	7%	8%	9%

Quota retirement: Quota is based on net new ACV.

Multi-year committed renewals do retire quota for amounts above the first year of renewal.

Annual renewals do NOT retire quota. Multi-year committed renewals do retire quota for amounts above the first year of renewal.

Accelerators: When quota is exceeded, 2% is added to each cell on the commission table.

Let me ask you a question. Why not simply use the licensed model for SaaS? Pay on the "total subscription value" (TSV) of the subscription contract? Below I illustrate why this might be a problem. When analyzing the Joel York model, which states you should pay only on ARR (or the monthly or quarterly variants), in the applied example the commission structure broke down as you see in the table below. His initial assumption (and we're focusing on commission %, not the other levers) was:

Joel York Typical Rep Compensation Scenario

- Target compensation @ quota = 150k = 75k base + 75k target commission @ quota
- Quota = 1M quota in ARR
- Unlimited upside for 1M+ ARR
- Commission % = 75k/1M = 7.5% per $1 ARR

Payout 1 = $7,500 = 7.5% x 100k ARR
Payout 2 = $9,000 = Payout 1 x (1 + 20% premium)
Payout 3 = $10,800 = Payout 2 x (1 + 20% premium)

The Sales Representative Shadow Compensation Spreadsheet

Sale Size	Overall Commission%	Commission	Marginal Commission
$100k upfront	7.5%	$7.5k	NA
$200k upfront	4.5%	$9k	1.5%
$300k upfront	3.6%	$10.8k	1.65%

Looked at this way, from the sales rep's viewpoint (and I think any compensation plan needs to do this before it's implemented), these are unattractive numbers. What is your take?

Let me take this point by point. First, I do believe, with the exception of deals with terms that exceed three years, SaaS firms should normally compensationensate on ARR for three primary reaons. They are:

- An ARR model keeps everyone aligned around what will normally be the most important compensation metric (at least for companies in the enterprise space).

- The ARR model I outline encourages making a deal **today.**

- My model makes it less likely you'll have to deal with clawbacks and other nasty issues in the event a subscription contract that runs over multiple years is canceled for whatever

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reason.

Second, note my model provides a more generous payout for the first year, 9% vs. Joel's 7.5% (he later revised his numbers to incorporate this new bench mark). That offsets the lower "marginal numbers in your "sales eye view" of compensation. And your exercise in compensation shadowing also points out the value of focusing on ARR.

Another important point I want to make is that in selling SaaS, it's important to keep it as simple as possible. You want to encourage a high volume of sales activity because in most cases, even with multi-year deals, the number of dollars you're dealing with are lower than in comparable license deals. As ***Softletter's*** sales research shows, the sales cycle is considerably faster in SaaS and your compensation plan needs to encourage that trend. The economy is currently working against multi-year deals and your sales force should not become overly concerned about them.

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RUTGERS PROFESSOR HAL SALZMAN ON HIGH TECH HIRING: "There's been this assumption that there's a global hierarchy of work, that all the high-end service work, knowledge work, R.&D. work would stay in U.S., and that all the lower-end work would be transferred to emerging markets,That hierarchy has been upset, to say the least. More and more of the innovation is coming out of the emerging markets, as part of this bottom-up push." (Quoted in ***The New York Times)***, 09/06/2010)

DANA BLANKENHORN AND PAULA ROONEY BACK ON OPEN SOURCE AND THE IPHONE: "In the 1980s, PC users had to live through 6 years of FUD, waiting for Microsoft or IBM to get their act together and deliver a graphical user interface similar to the Apple Mac, introduced in 1984. Apple had 5 years to own the market, yet its insistence on complete control meant it couldn't meet demand. Microsoft won.

It's happening again, Steve. Only it didn't take Microsoft 6 years to match you. Open source did it in two. And that's why Android phones now out-sell the iPhone. They're not better, they're just available, and you don't have to go into the 7th circle of Apple Hell to get one." (Quoted on http://www.zdnet.com/blog/open-source/open-source-benefits-from-7th-circle-of-apple-hell/7258?alertspromo=&tag=nl.rSINGLE, 08/31/2010)

ENTREPRENEUR COLUMNIST SCOTT STENIBERG ON SOCIAL GAMING: "A staggering 200 million social network users now play casual games like FarmVille and Pet Society monthly, which draw audiences numbering in the tens of millions. It's a sobering wake-up call compared to the previous benchmark for breakout industry success, online fantasy universe World of Warcraft, which boasts 11.5 million subscribers. Thanks to their low system requirements, familiar concepts and overall user-friendliness, these popular titles are single-handedly helping to grow the gaming market." (Quoted on http://www.entrepreneur.com/article/217302, 09/15/2010)

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