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**Publisher &
Managing Editor**
Merrill R. Chapman
rickchapman@softletter.com
860/663-0552

Editor
Donald K. Rosenberg
don@softletter.com
919/687-4172

Editor Emeritus
Jeffrey Tarter
jtarter@softletter.com
617/668-0028

Editorial office
Soft•letter
34 Sugar Hill Rd.
Killingworth, Conn.
06419
860/663-0552

Subscription office
United Communications
Group
11300 Rockville Pike
#1100
Rockville, Md. 20852
301/287-2718
866/313-0973
customer@softletter.com

www.softletter.com

Channel Optimization: Are You Giving the Channel Too Much?, Part I of II

by Nilofer Merchant, Rubicon

Given the squeeze-play on end-user prices, increased channel competition, and investor demands for steady—if not increasing—earnings, it is hard to believe that many companies have an untapped source of additional profits on current business.

In a recent worldwide channel economics study, Rubicon analyzed industry giants such as Microsoft, Symantec, Apple and Macromedia, as well as their top channel partners, and discovered that each, in their own way, was leaving money—profits—on the table. Neither the channel nor the vendor was using their channel investments optimally to bring products to market. The Rubicon study found that the investments many companies make in the channel fail to reverse loss of mindshare or improve returns. Most importantly, the study exposed that channel economics are changing in ways that challenge conventional wisdom.

What kind of impact, you say? We are talking about small changes that make a sizable impact. A dollar saved in the channel is a dollar that flows directly to your bottom line. A \$1 billion+ software company client of Rubicon expects to see earnings jump by \$10 million from optimizing a single point in channel spending. Not bad you think, but follow through on the logic. If the company earns a five percent return, the channel optimization results in a 20% earnings increase, a result welcomed by any investor or analyst.

Most companies fail to optimize their channel spending because they fail to view it with enough of a macro perspective. The key is to look at all forms of payment to the channel—not just margin, but direct, indirect and “soft dollar” spending—making sure each component is being used effectively to achieve your goals and not being lost or thrown away.

A proper view of channel economics must, at the very least, include the following expenses and investments towards the channel:

- Discounts (both the amount a vendor “provides” and the amount channel partners keep).

- MDF/Marketing spending.
- Rebates/SPIFs.
- Headcount placed in the account.
- Sales and marketing headcount to manage the channel.

So, why don't companies do this already? The primary reason is that at most software firms no single executive controls all these programs: there is no single "eye in the sky." For example, in some companies product management will own product discounts, MDF falls under the purview of field/corporate marketing, spifs and rebates are owned by sales and channel headcount can be divided between different groups. Some programs may be part of individual or department performance metrics, meaning that efforts to adjust one at the expense of another may ignite an internal turf war between corporate sales, marketing and the field. A holistic view (supported by at minimum a yearly review of channel expenditures) is needed to focus on benefits to the entire company. But how do you develop a holistic view?

The first step is to stop focusing on discounts. One issue vendors get hung up on is the channel discount—that is, your product sales margin. If you can move past the rhetoric however, you'll discover channel partners care about aggregate profit, not the individual components that contribute to it. In this way, their interests are more aligned with yours than you might think. Reseller sales reps increasingly are paid on profitability rather than product or vendor margin alone, so it is the overall contribution margin, not the form of contribution, that your product makes that is most important.

Contribution margin is the sum of all payments retained by the channel partner. It is important to consider total contribution margin because at the end of the day this determines reseller profitability and the channel's ongoing ability to create and support sales. Calculate your contribution margin by using the simple methodology below.

Purchase discount (intended margin)
-Additional discount given to customers by channel
+Additional payments and support (MDF, Rebates, etc.)

Contribution margin

Gaining and maintaining reseller mindshare for competitive and commodity products is a challenge when purchase discounts are the primary motivator. Trying to increase channel margins by deepening discounts is folly because all or most of the increase will be passed along to customers due to the competitive nature of the reseller environment. The customer wins, but you and your channel do not.

Nilofer Merchant, principal, Rubicon, 101 Church St., Los Gatos, Calif. 95030; 408/395-5534. E-mail: nilofer@rubiconconsulting.com. Website: www.rubiconconsulting.com

“Competitive sales environments drive resellers to give away margin in the form of additional customer discounts. For example, Symantec offers a 20% discount to the channel on one of its security products, but only 5% of that potential margin is retained by resellers due to the highly competitive nature of the market for that product. In contrast, Microsoft provides only a 10% margin upfront for many of its products, electing instead to invest its resources in back-end payments and demand generation.”

*—Nilofer Merchant
Rubicon*