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MIDWEST BUSINESS BROKERS AND INTERMEDIARIES

MBBI Newsletter September 2018

Beware of Customer Concentration Risk

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Based on my experience, one of the biggest risks in M&A is customer concentration risk. As a business owner, it is hard to avoid: if a customer is giving you orders, you generally take them! The next thing you know, your customer has 90% of your sales, and now they own you. We see it a lot in a wide range of industries.

The definition of customer concentration changes from buyer to buyer, some get nervous at greater than 20%, some at 25%. Some worry if the top 3 or 5 customers total more than 50% of sales. Or, the largest customer may be under 10%, but 80% of customers are in one particular sector, which creates sector risk (for example, the oil and gas industry).

In many cases, we have found that most financial buyers, such as private equity firms, will not touch deals that have concentration risk. That eliminates one of the most active parts of the M&A market at the moment. Also, many banks will not finance deals with customer concentration risk, which forces the buyer to put in more cash, which reduces ROI and valuation/terms.

However, strategic buyers may be interested in a business with high customer concentration but may put more of the deal into deferred payments. The seller loses control of the customer relationship after closing, which is risky (the buyer may change policies, pricing, etc. and lose the customer). A buyer may also want the owner to stay after closing for a longer period.

With a larger acquirer, a 50% customer for you might be a 5% customer for them, which represents less risk and less customer due diligence. A strategic buyer may really want to get a foot in the door in your major customer and may think that they can sell a lot more to them. Also, the large customer may be happy that the seller is being acquired by a larger company, which reduces the customer's supplier risk.

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The longer the customer has done business with the company, the more likely something bad is going to happen. This is a difficult pill for many owners to swallow. Unfortunately, most distressed companies we see had one large customer that evaporated or stopped paying. It is a risk that many owners are comfortable with, but buyers are usually nervous about.

Why are buyers and banks nervous about customer concentration risk?

1. One phone call and the business can evaporate overnight
2. Customer may use the sale of company as an opportunity to look for other suppliers, or change policies
3. Customer may themselves get acquired, have other sources or policies
4. Customer may be nervous about putting so much business into one supplier
5. Customer may have a relationship with the owner or another key person, such as a sales person. Once the owner is out of the picture, the relationship may change (or a key employee may take that customer to a competitor).
6. Customer may become distressed, start paying slowly or go bankrupt
7. Customer may move business overseas

We've been involved in deals on both the buy-side and sell-side that had up to 95% concentration. Deals can be completed in these circumstances, however, usually both valuation and terms suffer.

It can be a difficult and time-consuming process, but here are some steps a business can take to mitigate customer concentration risk:

1. Put resources into developing other customers. Incentivize the sales team to grow new business. If internal resources are not available, engage outside reps/distributors
2. Monitor the diversification efforts, make sure resources are not constantly pulled in to satisfy the top customer
3. Find ways to tie up customer: co-develop products, have customer invest in your business
4. Maintain gross margin discipline: no-bid projects that have low profitability
5. Be sure that the customer has multiple contact points in your company and is not reliant on one relationship
6. Get long-term contracts: if a customer's expansion requires you to invest in equipment and/or more employees, try to get something in return such as cancellation policies or make-or-take provisions.
7. Diversify into other products, services. For example, a US PCB shop could look into handling overseas boards or turnkey assemblies. For electronics manufacturers, expand into new services for other customers, or into new geographical areas.
8. From an early stage in the company, set a limit on the amount of business represented by any one customer, and set floors on gross margins.

Again, I know, not easy, and none of the above solutions are great. By working to diversify the customer base, a business owner can make the company less risky, more valuable, and easier to acquire.

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