Value Driver #3: Establishing a Diversified Customer Base

Put yourself in a buyer's shoes, and you'll find yourself shuffling past companies with great management teams and excellent systems, but whose cash flow is dependent on one or two customers. Would you spend millions of dollars on a business only to have those customers leave after you've acquired the company? As a seller, building your financial well-being to your former company and its customer is likely to be the last thing you want.

Diversifying Your Customer Base

Given that fact, an important driver of a company's value is having a customer base in which no single client accounts for more than roughly 10% of total sales. A large customer base helps to insulate a company from the loss of any single customer.

As a future seller, achieving this can be problematic when you are building a business with limited resources, and only one or two good customers account for most of your product or service sales. If you find yourself in this situation, there are a couple strategies to get you out of it. The first one is to reinvest your profits in additional capacity; something that will make developing a broader customer base possible. A second strategy is to diversify by buying smaller competitors.

The issue of high customer concentration often gets in the way of the third-party sale of an otherwise attractive company. To help illustrate, let's look at a hypothetical case study of a profitable fabricator and installer of commercial heating systems called Calescent.

Case Study

Calescent's EBITDA exceeded $3 million per year, a strong management team was in place, and all systems were a go. So thought Ken and Josie, its owners, until their advisor discovered that more than 85% of the company's revenues and profits were derived from just eight customers. The owners didn't quite understand why that presented a problem. After all, those eight customers were long-time customers and provided a steadily increasing cash flow to the business. Ken asked, "Why should we try to diversify when it is all we can do to keep up with the new business from our existing customers?"

Calescent's most attractive buyer (a Fortune 100 company) provided the answer. It insisted on meeting with each of the eight customers to determine their willingness to remain with the company after it was sold.

Ken and Josie objected vehemently. "What will our loyal customers think - and do - if they assume that we're selling our business? Will they stay as customers? What happens if we don't end up selling and they leave anyway?" These owners realized that losing even one customer would be a financial set-back and losing two or three spelled disaster. Not only would the sale fall through, but the company might be thrown into a financial tailspin.

These same insights prompted the would-be buyer to demand the interviews. It was not prepared to pay $20 million for a business whose customer base and cash flow might well decrease by 15 to 45% overnight - simply because the business was under new ownership.

Ken and Josie faced a dilemma: the only way to pursue the sale was to allow this buyer to meet with their customers. If they refused, the sale process was over and their dreams of cashing out and moving on to the next chapter of their lives would be put on hold indefinitely. If they allowed the buyer to meet their customers, the sale might fall through for totally unrelated reasons, but Calescent's relationships with its customers might be irretrievably harmed. Even if the sale did close, their customers' potential loss of confidence might cause them to bolt and jeopardize Josie and Ken's earn outs. Had Calescent had even 20 customers, Ken and Josie would not have found themselves in this situation.

In the end, Ken and Josie did allow the prospective buyer to meet with their customers. All indicated that they would remain customers if the service level remained high. As expected, the buyer's terms included that the sale price would be reduced on a percentage basis if any customer left within 30 months after the sale. Tough terms, but the only ones that the buyer would accept.

Conclusion

As the Calescent case study illustrates, establishing a diversified customer base can play a critical role in the sale of a business. A trusted advisor can help you help you analyze your customer base; including comparing to customer concentration information specific to your industry.

For more information or to learn how L. Harris Partners can help you grow your business:

L.Harris Partners

Phone 952.944.3303
tom.siders@lharrispartners.com
www.lharrispartners.com