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Customer Concentration: The Real Risks and Potential Benefits

There's more to concentration than a revenue pie chart.

by David Working

Business owners often spend years developing deep relationships with key customers, and many owners can point to a single customer that was the catalyst for a pivotal growth stage in their business's history. But when it comes time for the sale of a business, suddenly potential buyers start to view those relationships as a source of risk instead of strength. "Customer concentration," where a meaningful portion of sales come from a single customer, is rarely viewed as a positive characteristic. It is our view, however, that not every concentrated customer base is the same under the hood. Helping buyers understand these differences can keep engagement levels high, and can positively influence transaction value.

Customer concentration is a relatively easy reason to pass on an investment. A buyer will view any externality as a potential risk to a business, and customers are an externality that can be difficult to understand and predict. When a business is dependent on a small number of those outside actors, any insulation the business has against freak events becomes very thin. Unless a buyer has a great reason to spend time understanding the nature and depth of a business's customer relationships, when faced with meaningful customer concentration (usually 30-50% of sales to a single customer), it is an easy decision for a buyer to choose to spend their time elsewhere.

However, simply looking at revenue figures doesn't always tell the whole story. Assessing risk is difficult, so buyers lean on proxies of risk to help them make timely decisions, especially early in a process. If a buyer can be helped to understand why the true risk is not accurately captured in a "sales by customer" table, then they are likely to keep engaged further into a process, maximizing the perception of value and the likelihood of participating as a competitive bidder. The following case studies are examples of where the "real" risk of a revenue base was not reflected by its relative distribution of customers:

1. *Identifying the true customer.* A business was selling a technical product into pharmaceutical companies' research and development departments. On the surface, revenue appeared heavily concentrated – over 80% came from a single pharma company. But its true customers were research groups, who controlled their own budgets and purchasing decisions, and operated independently from each other under the same corporate umbrella. Within this key customer, sales were made to more than 25 research groups across multiple disease areas and business units—each with its own unique dynamics and risk profile. In this case, referring to the corporate parent as the "customer" didn't capture the true concentration, and the customer diversification was in reality quite broad.

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2. *Mutual dependency.* Another business, a consumer products distributor, had developed a 15+ year relationship with its key customer, a national retailer. This customer represented more than 85% of the business's revenue. Many businesses having this characteristic would be highly risky, as they would be one of many undifferentiated service providers selling to a customer with tremendous buying power and low switching costs. Instead, in this case, the national retailer was deeply dependent on this distributor for a key segment; the two companies had spent years entwining their supply chains, information systems, and risk sharing, and had created a very high margin result for each. No competitor offered a possible substitute to the large retailer. Given these attributes, this distributor could point to its key customer as a source of strength, not risk.

3. *Immediate vs. end customer.* A third business is a counter-example, as it appeared highly diversified on the surface, yet was much riskier than at first glance. This business was a supplier of tooling and parts to a broad base of aircraft maintenance organizations across the United States. But a deeper dive into its products' end use showed that over 70% of its parts and tooling were used to service a single Boeing airframe. While its immediate customers didn't appear to show meaningful concentration, in reality, the business had significant exposure to the future of a single product line from one OEM. In this case, the traditional measure of customer concentration did not capture the true revenue risk.

The common theme in each of these case studies is that defining the true "customer"—the owners of the end use case, the purchasing decision, the budget, or all of the above—and putting each of a business's customers in

(continued p.2)

context with its own end market, competitors, and suppliers uncovers the inherent risk of the business's revenue base.

An interesting case study that is playing out in our marketplace is buyers' treatment of a business's significant exposure to the Amazon marketplace. For many private equity buyers, these businesses are excepted from customer concentration rules, as it is not believed to be the same source of risk that another dominant customer may represent. Amazon is less viewed as a customer and more as a channel, since the thinking goes that Amazon doesn't view a supplier as a supplier in traditional terms. Amazon doesn't restrict itself to certain suppliers or lock in contracts; any product that sells is as good as any other product. To a private equity buyer familiar with the Amazon marketplace and its dynamics, heavy concentration within the Amazon channel is a risk that doesn't preclude a business from deeper analysis.

While a quick look at a pie chart of "revenue by customer" shows the tip of the iceberg, it often does not answer the question that buyers are really asking: how risky is this company's revenue? A business in a sale process can avoid failing buyers' early filters and can maximize the universe of attracted buyers by carefully defining its customers and characterizing its customer relationships, thereby increasing the likelihood of competition deeper into the process. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions through three service lines: sell-side M&A, acquisition and investment advice, and direct investing. For more information on Zachary Scott, go to **ZacharyScott.com.**

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