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Exit Planning
NAVIGATOR
Exit Planning Strategies for the Entrepreneur

Issue 129

Value Drivers: Establishing a Diversified Customer Base

Put on those buyer's shoes one more time 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. Why would buyers spend millions of dollars on a business only to have those customers go elsewhere after they've acquired the company? At the very most, a prudent buyer could structure a buyout to protect against the loss of a key customer, probably by making much of the purchase price contingent or requiring the seller to carry a note for the bulk of the purchase price. As a seller, binding your financial well being (for several years) to your former company and its customer is likely to be the last scenario you prefer.

Another important value driver, then, is the development of a customer base in which no single client accounts for more than approximately 10 percent of total sales. It is important to talk to a trusted advisor about customer concentration information specific to your industry. A large customer base helps to insulate a company from the loss of any single customer.

Achieving this objective can be problematic when you are building a business with limited resources and one or two good customers are willing to pay for everything you can deliver. If this is the situation in which you find yourself, it is important to consider beginning now to: (i) reinvest your profits into additional capacity that will make developing a broader customer base possible, and/or (ii) acquire diversification by buying smaller competitors.

High customer concentration can prevent a third-party sale of an otherwise attractive company. Witness the situation with Double L Boilers, a hypothetical case study of a profitable fabricator and installer of commercial heating systems.

Double L's EBITDA exceeded $3 million per year, a strong management team was in place and all systems were "go." So thought Lloyd and Larry, its owners, until the investment bankers analyzed the company's customer base and discovered that more than 85 percent of the company's revenues and profits derived from eight customers. The owners didn't quite understand why that fact presented a problem. After all, those eight customers were long-time customers and provided a steadily increasing cash flow to the business. Lloyd 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?"

Double L'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.

Lloyd and Larry 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

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losing even one customer would be a financial setback 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 percent overnight – simply because the business was under new ownership.

Lloyd and Larry faced a true 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 into new 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 Double L's relationship 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 Larry and Lloyds' earn outs. Had this business had even 20 customers, the situation would not have surfaced.

In the end, Lloyd and Larry 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.

As the Double L case study illustrates, it can be very important to establish a diversified customer base early in the process of preparing your business exit. After you have focused on this important value driver, the next step to creating a company with strong value drivers is to establish realistic growth strategies. The next **Exit Planning Navigator®** article will discuss this value driver in more detail.

If you have questions about increasing the value of your business prior to your exit, please contact Kevin Short, Managing Director (kshort@claytoncapitalpartners.com).

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