ALLIED ADVISERS

Customer Concentration

Hurdle or Opportunity?

As middle market M&A bankers, we have successfully advised technology businesses which have a significant percentage of their revenue coming from a few clients. This “**client concentration**” often becomes the focus (no pun intended) of buyers and investors in transactions, with reactions ranging on a spectrum from “we like it” to “this a major problem”. More often than not, the sentiment is biased to the negative.

Customer concentration is a natural consequence of how emerging growth companies evolve. In the early stages of a technology business, entrepreneurs are focused on developing a product or service capability and deploying the solution with a customer who they view as most ready to receive them, or with whom they have the best relationship – leading to an optimal outcome. That early customer often becomes the anchor client for the company. In the absence of a strong sales engine, emerging growth companies scale around the anchor client and gradually diversify their revenues with additional customers, but the anchor client(s) may continue to remain the largest contributor of revenues for years. In other instances, a well-established company with a fragmented client base may land a “whale” along their journey, and this large client ends up dominating the revenue contribution. We have been involved in situation where a client had Google contributing over 50% of its revenues which had it merits and concerns. Also common are scenarios where the company’s product is purpose-built for the large enterprise market where sales cycles are extended to several quarters due to deal size, so getting to a diversity of customers may take several years.

Whatever is the reason for customer concentration, it presents a material risk to investors in a M&A or a financing transaction – the loss of the dominating customer(s) could significantly impact the value of the target business very quickly, and it could take considerable amount of time to replace the lost revenues with new business. Buyers and investors therefore diligence with high scrutiny the following aspects of the target business in situations where there are a few large customers driving most of the revenue:

- **Tenure of the large customers with the target company** – long tenures indicate a strong and sustainable relationship that is more likely to endure post transaction
- **Financial profile of the end customer** and whether they are a desirable paying customer
- **Dependency of the customer relationships on key person(s) at the target company** – the retention of such key person(s) becomes vital to the success of the transaction

Length of the customer contracts – risk is mitigated if the contracts are long-term (multiple years) and auto renew

Stickiness and switching costs – high dependency of the large customers on the target's solutions, making rip-and-replace an expensive proposition for the customers. Some solutions tend to be stickier than others; for example, companies might spend a good amount on customization for a SaaS product, which creates inertia to change vendors. In other cases, the customer may have been getting AI / ML solutions based on data sets obtained from the vendor and changing them creates risks

Approvals and Change of Ownership clauses with the large customers – the requirement for the target company to obtain approvals from the large customers for transferring their contracts to the buyer creates significant risk for the transaction. Buyers and Investors will also look at "change of control" clauses and ability to move the customer relationship contractually following the transaction

At what levels does client concentration become an issue?

There are no rules of thumb and it depends on the risk appetite of the investor. Typically, a single customer accounting for more than 25% of revenue or top three customers driving more than 50% of revenue is considered concentration. However, the considerations discussed above could materially change the perception of concentration risk in the eyes of the buyer or investor.

Following are a few key takeaways on customer concentration:

Private equity investors

Private equity investors are particularly loath to client concentration given the financial risks that the loss of key customers presents to the profitability of the business and potentially to covenants on debt that is often used in conjunction with equity to finance the deal

- PEs making a platform investment may have contingencies in the deal terms in the form of earnouts hinged to renewal of primary client contracts or sustainability of profit margins, coupled with a lower level of payment at closing. They may take into consideration IP value, client quality and growth metrics in determining the transaction structure
- Investors who can see past the client concentration may face hurdles with lenders financing the deal; this could impact valuation
- There may be opportunities with portfolio companies of PEs who see synergies with the primary clients, technology and team

Strategic buyers

Strategic buyers present a better opportunity as acquirors of businesses with client concentration for the following reasons:

- Larger buyers may view the primary customer as another large account or that it strengthens their relationship with the key customers where they may be overlap
- Smaller buyers who have their own concentration issues may view a large customer as diversifying their client base
- The primary customer of the selling business could become the acquiror, driven by strong interest in the products or services offered by the company and not lose the technology to competitors who may not want to serve the customer base post change of control
- The synergistic value of a target's technology or team could supersede concentration risks for a strategic buyer

Valuation implications

Valuation implications range are broad and situation dependent from reduction of 1-4x multiple of revenue (for emerging growth) or 2-5x multiple of EBITDA (for mature companies), to none with appropriate structuring

- The profile of the business and the size of the market opportunity could be attractive enough for the investor to bid with a lower discount
- Buyers who have an angle with the primary customers that ensures continuity and account growth may be inclined to offer a competitive value
- Sellers should expect significant diligence of primary client relationships and structures like earnouts or holdbacks in the transaction to mitigate their risks

Allied professionals have significant experience working with clients who face customer concentration issues. We have helped achieve desirable outcomes in transactions where clients have had customer concentration issues. These transactions are no doubt more challenging, but a well-run competitive process, good positioning and smart deal structuring can result in happy sellers and buyers who are comfortable in the concentration being a potential plus.