DON'T OVERVALUE YOUR TARGET'S CUSTOMERS

Overview: When access to a company's customer base is the primary motivation for an acquisition, buyers need to ensure those customers really are as valuable as they seem. If not, the purchase could be a very expensive mistake. This article advises buyers to perform thorough financial due diligence, talk directly with customers and examine the target company's management practices.

Article

Depending on your strategic objectives, obtaining access to a target company's customer base can be an excellent reason to make an acquisition. By expanding the number and quality of customers, you may instantly increase demand for your products or services.

But be careful. If customer access is your primary motivation for buying, you'll need to ensure those customers really are as valuable to your business as they seem. If not, you could be making a very expensive mistake.

Account for receivables

The due diligence stage of an M&A deal is where you have the best opportunity to evaluate the target's customers. Start with the most recent financial statements and focus specifically on the company's accounts receivable. Make sure the balance sheet's receivables are collectible and not simply "paper" assets. Note whether large and long-running receivables are on the books and, if so, find out why the company has had trouble obtaining payment.

Also review collection documents to determine how quickly the company has been able to collect on customer charges. If you discover that it has had a history of problems turning receivables into hard cash, find out why — as well as whether the problem is endemic or only an occasional issue.

Go to the source

Talking directly to customers is also important. How loyal do they seem? Loyal customers are more likely to retain their relationships with the company after it's acquired. If, on the other hand, they seem dissatisfied with their current business relationship, they may use a change in ownership as an excuse to find a new vendor.

Also note which customers are in sound financial shape and meet their obligations. Financially distressed or late-paying customers will be of little value, no matter how big their orders. But if they're financially healthy, your target's largest customers should be your primary focus. Consider how revenues would fare if the target company lost one or more of these sources. Would you still want to buy the business — or pay as much as you originally intended?

Even with the best deals, it's not unusual to lose a handful of customers during the integration process. If that handful includes the company's most valuable revenue sources, a deal that looked good at closing will almost immediately lose significant value. So, in general, the larger and more diversified your target's customer base, the better.

Consider management

Your target's management practices also can tell you a lot about the value of its customer relationships. For example, do managers seem to spend an inordinate amount of time on collections? If so, it could suggest a number of potential problems — that the company uses resources inefficiently, is experiencing financial difficulties or has low standards when it comes to customers (and, potentially, other types of relationships).

Also ask how much time managers devote to identifying and winning new business. Has the company tried but failed to generate new sales recently? If so, determine why, and pay particular attention to what this says about the company's ability to grow.

For example, if sales are falling because your target's customers are flocking to a new competitor with superior products, your entire deal could be misguided. On the other hand, if sales are falling because your target company's sales department is understaffed, you could have a big growth opportunity. With greater financial resources, you may be able to turn a neglected customer database into gold.

Beyond face value

If you're pursuing an acquisition to gain new customers, be sure to use the due diligence stage wisely. What looks dazzling on paper might just be window dressing, and you could end up paying too much for too little.