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Using the Voice of the Customer to Mitigate M&A Risk

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A recent Deloitte survey of M&A dealmakers found that “customer retention and expansion” is the most important factor in achieving a successful deal.

In B2B deals, the ability to retain and grow the customer base post-close is even more critical. This is because the typical B2B firm has a highly concentrated customer base – 20% of accounts tend to generate 80% or more of revenue.

Therefore, B2B firms with a high degree of customer concentration are very vulnerable to post-close customer attrition risk. If a single top account were to lower its spend post-close, there would be a material impact on the valuation and the long-term growth outlook for the company.

If we know the primary risk associated with B2B M&A deals is customer attrition, then why are acquirers not allocating more resources to mitigating this risk by conducting customer due diligence?

Perhaps the answer is because many customer due diligence programs are poorly designed and add little value. They are often done internally, treated as cursory reference checks, and use methodologies which only generate topical findings.

Fortunately, there is a better way. Customer due diligence programs which are built on the Voice of the Customer (VOC) methodology are much more likely to generate insights and recommendations to help mitigate customer-related risks.

In this second article in a four-part series, we will present a case study that demonstrates how the VOC methodology can be used to conduct rigorous customer due diligence that ultimately provides insights to offset the risks associated with customer concentration.

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The Challenge

Our client, a private equity firm, was evaluating the purchase of a manufacturer of plastic assemblies and components.

The target company had a highly concentrated customer base. Its top 15 customers accounted for 86% of revenue. More concerning, its top two customers accounted for just over half (53%) of revenue, and its top customer accounted for one-third (35%) of revenue.

When our private equity client inquired about the stability of these 15 critical accounts, the target company's management claimed they were secure. As proof, management pointed to the long tenure – 13 years on average – of these customer relationships. In addition, management cited the high switching costs associated with any potential supplier changeover scenario as a deterrent for customer attrition.

Still, with the success of the deal so dependent on the continued revenue of a handful of customers, the private equity firm commissioned Strategex to conduct in-depth customer due diligence built on the VOC methodology.

Strategex and the private equity firm collaborated to develop a customer due diligence program that was designed to:

1. Assess the strength and stability of key accounts
2. Identify at-risk accounts and understand what steps would have to be taken post-close to retain these customers
3. Estimate the future growth outlook among key accounts

The Solution

To generate the insights needed to address these objectives, Strategex conducted 15 customer interviews across 9 of the company's top accounts. All of the interviews were conducted over the phone and, on average, lasted 20 minutes.

The engagement was funded by the private equity firm but sponsored by the target company. This approach allowed Strategex executive interviewers to position the

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survey as a customer satisfaction interview. Thus, they never had to disclose that a deal was under consideration.

The researchers conducting the interviews followed an objective-based discussion guide that was prepared in collaboration with our client.

As interviews were completed, transcripts of each conversation were provided to the client on an ongoing basis. Once all of the data was collected, the results were aggregated, coded, and synthesized. Key themes and recommendations were outlined in a management report, which included an in-depth analysis of the data and customer commentary in total, but also across a variety of segments.

The Results

The results of Strategex's due diligence revealed that the state of customer relationships was in a precarious position.

The target company had a Net Promoter Score® (NPS®) of +22, which is indicative of a company that is performing adequately on the fundamentals, but with plenty of opportunity for improvement. Consequently, firms with a NPS® in the +10 to +35 range tend to be losing or maintaining market share, which was certainly the case with the target company (its revenue had only increased 0.5% over a three-year period).

Furthermore, most customers were categorized as "Passives." Passive customers are those who are satisfied but not necessarily loyal. These customers tend to be actively evaluating competitors, often push for price concessions, and are generally more expensive to service over the lifecycle of the customer relationship.

The findings were even more concerning when analyzed at an account level. It was revealed that the top customer (the one that accounted for 35% of revenue) was:

- A Passive customer
- Actively vetting two competitive suppliers
- Not planning to renew their contract with the target company, which was coming up for review
- Planning to exclude the target company from future RFPs

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- Forecasting lower spend with the target company in the coming years

To sum things up in the words of this number one customer by revenue:

"There isn't anything I like about them (the target company). Our current plan is that, in two years, our volume with (target company) is going to start going down."

A well-designed customer due diligence program does more than diagnose issues, it also provides prescriptions. As such, Strategex's work identified precise actions that would have to be taken in order to retain this account post-close, including:

- Remedy product quality and consistency issues
- Decrease the rate of staff turnover
- Update technology and manufacturing capabilities

In response to these findings, our private equity client lowered their offer for the company. The target company's management walked away from the table, and at the end of the process, our client told us:

"You saved me $400 million and a lot of headaches."

Anthony Bahr (abahr@strategex.com) is a Vice President in Strategex's Voice of the Customer Strategic Practice. Through the VOC process, he provides deep insights into a customer's level of satisfaction and loyalty, as well as competitive positioning, innovation pathways, pricing optimization, etc. Ultimately, his work enables clients to transform research findings into actionable growth strategies. Anthony holds a BBA from Loyola University Chicago and graduate degrees from the University of Oklahoma and University of Chicago.