Behind the Numbers
Extracting Insights from a Client Quality Audit

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Two competitors are generating roughly the same level of revenue by selling essentially identical products in a largely commoditized market. Private equity investors ask for the standard data on the 20 largest customers and find markedly different patterns.

Company A has a highly concentrated list, with the top 20 accounting for roughly 50 percent of revenue. Almost every customer on the list has been on board for 10 to 20 years.

Company B has very little concentration, with the top 20 comprising less than 10 percent of revenue. Most customers on the list have been buyers for five years or less.

Of course, these numbers provide absolutely no insight into which company is the more attractive investment.

Company A seems riskier, with a highly concentrated base, but the biggest customers have been with the company a long, long time. That could mean the company is good at building and maintaining relationships, or it could mean they haven't brought in a big account in more than a decade. It could also mean the balance of economic power is strongly against the company in play.

Company B seems to be thriving without the risk associated with a top-heavy client list. That probably means the biggest clients lack the economic power to force sharp concessions that threaten earnings. Of course, it could also mean the company has no talent for building strong, long-lasting relationships.

Lack of customer insights is a well-known but infrequently addressed limitation of the due diligence process. Although investors and buyers voice concerns about the strength of customer allegiance, measurement of this critical success factor is cursory in many DD projects. Data is collected, boxes are checked, but the investor learns little about underlying risk - or opportunity.

In the past, we've discussed the insight gaps resulting from inadequate customer assessment. Today, let's look at the hard data gaps that can be closed with relative ease. The Client Quality Audit should begin with analysis of the lifecycle of an account. What are the patterns and what do they indicate for the future?

- Do accounts grow over time or shrink?
- Do customers increase or decrease the number of SKUs they buy?
- Does the company need to re-sell its accounts every year with new price concessions?
- Do customers become more or less dependent on the company as a resource?
- How have these patterns changed in the past few years?
- If these trends continue, is the company a better or worse investment than its recent performance might indicate?

All these insights can be discerned from an analysis of numbers that should be readily available in the due diligence process. Before the first customer is called, the team can identify the issues that need to be addressed in the interview process.

As an example, the pattern of sales across the life of a relationship might have shifted in recent years. Longer-term customers might have been more stable, for example, while recently acquired relationships are more volatile. The seven-year itch for clients might now be a two-year, mandatory reassessment.

If that's the case, any survey of customers should be weighted to emphasize customers who have been with the company long enough to offer a valid assessment, but also likely to be reviewing the relationship in the coming year.

As described in the example above, the Client Quality Audit uses lifecycle data to identify the customers to be interviewed. While most due diligence processes focus on the largest customers, more recent relationships could offer greater insights into both risk and opportunity.

Similarly, the patterns that emerge from the audit will indicate which questions to ask. If margins tend to decline over time, for example, interview questions could be phrased to identify the reasons for changes in customer purchasing or payment patterns.

While most due diligence exercises focus primarily on risk avoidance, a Client Quality Audit offers assessments of both risk and opportunity. As a result, the audit technique can be applied in an integration environment to identify the landmines that might await the integration team.

Understanding how the transaction looks to customers - and how the company is assessed by them - is an early-warning system for integration teams.

Consider, for example, our original scenario of two companies in a commodity market. Clearly, the mix and match of customer relationships is different for the two companies. Which components of customer service, marketing, pricing, website operation, or other factors should be incorporated into a consolidated system?

By bringing the customer into the equation in a productive way, the Client Quality Audit identifies opportunity to accelerate returns from a transaction while reducing the likelihood of costly missteps. Engaging customers in the conversation is always a best practice, but its value is magnified when new investment is in play.

About the Author
Michael Rosenbaum is founder of Quadrant Five (www.quadrantfivefocus.com) and a highly experienced consultant to corporate management teams. His latest book, *Six Tires, No Plan*, chronicles the life and management style of Discount Tire Company founder Bruce Halle.

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