CUSTOMER DUE DILIGENCE BEST PRACTICES

Customer due diligence is just one narrow little slice of the due diligence pie, but in many instances, it can be the most critical piece. And there are only a handful of basic customer questions that must be answered in every acquisition, so it is important to get it right.

Why Not Conduct the Research Internally

Many acquirers prefer to conduct customer due diligence in-house, but there are a number of benefits to outsourcing.

The first issue is anonymity and objectivity. When the acquirer calls on a prospective customer, the customer is likely to figure out that an acquisition is taking place. This may impact how they answer certain questions. Furthermore, most of our clients do not have the time or resources to conduct this customer research effectively on their own. This work is not easy. There are difficulties associated with gaining candid insights about customers that are often large and sophisticated, and brands that often have only limited awareness and equity. Professional research analysts leverage the client's time by analyzing many informational puzzle pieces.

Trained, skilled, and experienced researchers recognize that their job is not merely about answering questions. The real role is to gather insights through interactive conversations, that when synthesized in the whole, will help the research firm to answer the client's big-picture dilemma (e.g., should we acquire this company).

Who Does this Research?

The best primary researchers are "Renaissance" men and women. They are knowledgeable about a wide range of subjects and are able to carry on conversations fluently, with interest, and in a way that generates enthusiasm from the conversational participant. Analysts build rapport with phone contacts and develop meaningful, interesting, two-sided, dynamic, and mutually useful conversations with their contacts.

Most professional analysts have years of experience, often in other analytical arenas, and are able to spot trends and identify patterns efficiently. An objective third-party effort can reveal specific, tangible insights to help in assessing the safety of existing revenue streams and the opportunities to expand revenue streams with current (or prospective) customers.

Intelligent researchers do not merely rely on a script of questions. They ask the contact the next logical follow-up question in response to what the interviewee has just said. They are experts in the art of the conversation. Recent college graduates are not ideally suited to this task.

How Many Conversations is The Right Number?

For qualitative researchers, the number of contacts is far less important than the quality of the people being interviewed (and hence the quality of what is being learned). Having low-level, relatively useless survey-like dialogs with a thousand people will prove less fruitful than having deep-dive, interactive, dynamic conversations with, say, twenty industry experts.

How loyal are the Acquisition Target's Customers?

The key issues we are trying to understand involve the following two questions: "Are customers satisfied?" And "What is the threat that customers will seek another source of supply?"

Every industry's customers can be displayed on a continuum from no interest in switching suppliers to high interest in switching. Even in industries with high perceived customer switching costs, some customers are always looking for a better supplier and some will remain loyal forever. Therefore, it is not enough to know that a customer is dissatisfied with its current supplier. It must be willing and interested to take the steps necessary to switch suppliers. The pains and difficulties associated with remaining with the supplier must be greater than the pains and difficulties associated with switching.

It is important to understand not only the likelihood of switching, but the reasons a switch might occur. (Actions on the part of the acquisition target can quickly mitigate this risk.)

What are the Customers' Purchase Decision Factors?

Rather than simply listening to complaints and taking them at face value, it is important to assess the impact these complaints will have on a switching decision. For example, suppose you learn that a customer is upset about the appearance of its supplier's product. That information is only worthwhile if "product appearance" truly plays a role in that customer's purchase decision process.

By researching customer purchase decision factors, you will learn, from each customer:

1. How important is price compared to other factors? How do you define price? (Is it the initial upfront price of a good or service, or the long-term costs associated with the product or service?) At what level of price increase would a switch of suppliers occur?
2. How important is quality? What aspects of quality are important? Define quality?
3. How important is service? What aspects of service are important? Define service?
4. What other factors do you consider? How important are they?

Compare the prioritized list of customer purchase decision factors (for each segment of customers) to the target company's perceived and real strengths and weaknesses. Doing so enables one to assess if its strengths really matter. A target company is much more attractive if its strengths are in areas of critical importance to customers than one which has strengths in areas that are unimportant to customers.

Taking into Account These Purchase Decision Factors, How Does the Target Stack Up Against Competitors in the Market?

It is useful to understand how each customer, prospect, and lost account rates the target company in terms of each purchase decision factor. In other words, if Customer X considers long-term product operation cost, technical service availability, and product design as its top three factors, how does it rate your target company's performance in those three areas vs. the competition's performance?

One can analyze these insights to determine the strengths and weaknesses of the competitors. It is also helpful to determine which competitor has the most strength in areas that are critically important to the largest segment of customers.

What are the Customers' Unmet Needs?

The last step in assessing the customer relationships is to examine all of the customers' unmet needs. Identifying the customers', prospects', and lost accounts' unmet needs can be very revealing. Do those unmet needs happen to fall in areas that are critically important to customers? Are there easy changes the acquisition target company could make that would cause its customer relationships to become more stable? You may learn that many of your customers would like improved access to your technical service personnel, for example. Or they may want to be able to make purchase order changes later than they are able to do so at present. They may expect better attention to detail in shipping complete orders at once. These changes, which may not cost a lot of money or require a tremendously complicated solution, may go a long way toward satisfying current customers.

However, in some cases, the customers' unmet needs are not as straightforward. "The salesperson that I have to deal with is a complete bully. I do not like his personality or his tactics. I know that his products are the best in the industry, but I may switch suppliers just so I do not have to deal with him." Uncovering this kind of unmet need is obviously important. It will probably require using an objective, candid third-party research firm to uncover this kind of dissatisfaction.

There are even more important discoveries that can be made through customer due diligence. Hearing from the second largest customer that it is actively looking for a new source of supply can be extremely impactful on the acquisition process. But is this discovery too late? What are the reasons for the dissatisfaction? The only way to gain these kinds of insights reliably is to use objective third parties calling in blind, with no announced connection to the supplier.

Regardless of the type of unmet needs that you discover, gaining insights about them is important. You will be able to identify the risks of losing customers on a case-by-case basis. The target company will be able to offer more customized solutions, post-closing (assuming the acquisition goes through).

Conclusions.

Because it directly impacts the confidence level you have in future cash flows, customer due diligence is extremely important. And it is critical to get the process right. Utilize third-party experts who have conversations with buyers on a daily basis. Choose research and consulting firms who work on a blind basis (without the target company tee-ing up the conversations) with experienced, well-educated "Renaissance people." And by all means, do not merely think of the customer due diligence as a "check the box" exercise; it can be extremely useful for the management team and the board in developing growth strategies after the acquisition is complete.

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