Value scorecard driver: breaking down customer concentration

Our Technology M&A team has developed a proprietary value scorecard tool to enable us to look at relevant driver that helps assess businesses’ value. Each quarter we will look at a different driver. This quarter, we explore the nuances of customer concentration for IT and tech-enabled businesses.

What is customer concentration and what does it signal?

Customer concentration is a critical business metric for companies across sectors. For most IT and tech-enabled service businesses, it is one of the top issues potential acquirers focus on. But what should be a nuanced analysis is too often painted with a broad brush. This superficial look at concentration as a binary “high” or “low” overlooks important considerations on what it means for value.

In this edition of our Recap, we unpack these considerations for IT services businesses.

Put simply, customer concentration is the extent of revenue diversification across your customer base. Often it is calculated by looking at revenue from each customer as a percentage of total revenue. The number of customers included in this calculation depends on the business and the overall size of the customer base. Typically looking at the Top 1, 5, 10 and 25 customers gives you a good sense of the diversification of a business’s revenues, but for businesses serving small and medium enterprises, acquirers may look beyond that.

It makes sense that a high level of concentration would be, everything else being equal, a negative value driver for the business. More revenue with fewer customers means losing any of your top customers hurts the business in an outsized way and those customers have stronger leverage to negotiate discounts, payment terms and more. In IT services, particularly with value-added resellers, concentration can be meaningful given the volume of channels that can flow through enterprise accounts.

Ideal customer concentration metrics vary quite drastically depending on customer type, volume and the specifics surrounding the solution offering. Generally, for IT-enabled solution providers, if customer volume is low and deal volumes are large, the ideal concentration mix for each customer is below 10% of revenue. Conversely, if the solution offering supports a larger customer volume with lower average contract values, concentrations below 1% for each customer or 10% for the top 5 customers generally indicates a diverse customer base.1,2

Taking customer concentration one step further

The narrative around customer concentration is always more nuanced than a percentage. The considerations that should be looked at for each significant customer include:

- Do you have preferred vendor status for that customer?
- Do you have more than one offering for that customer, with decision-making split across multiple individuals?
- Are any of the services you offer highly specialized or mission-critical providing a strategic moat against competition?
- Do you have recurring contractual agreements that provide continuity of service and revenue visibility for the future?
- Are your offerings jointly developed or marketed to end customers?
- Is there something proprietary about your offering that makes it differentiated as opposed to commoditized?

Forming this narrative for each major customer or positioning your business by enhancing these elements is critical during a transaction.

Finally, concentration is not always a bad thing. Positive attributes of customer concentration include:

- Circumstances where one vertical lends its reputation to the rest of the business (i.e., providing cybersecurity to a government agency)

Applying the brand power of a large customer, or using a cornerstone customer (i.e., large financial services institutions with complex IT requirements) as a blueprint to design scalable processes to increase cross selling opportunities.

What does this mean for value?

Companies must monitor their customer concentration and improve it over time, but shouldn’t lose sight of the other factors above. As an advisor, we help you explore this nuance to better understand your true customer concentration risk and form a narrative to deal with it during a transaction process.

Want to learn more about evaluating your business with our proprietary Value Scorecard? Contact one of our team members.

---

1 From “Klipfolio Metrics HQ” October 12, 2022.
1 Priyanka Arora, Metric Stack Newsletter, November 15, 2021.
EY transaction snapshot

EY advised Brightworks Interactive Marketing Inc. (the “Company”) and its shareholder on a majority sale of the Company to Believeco:Partners (the “Buyer”).

TO LEARN MORE

Sid Nair
Canada Technology M&A Leader, Senior Vice President
+1 416 943 3404 | sid.nair@ca.ey.com

Devon MacMurray
Vice President
+1 416 932 6131 | devon.macmurray@ca.ey.com

About the Company

Brightworks is an established, award winning, full-service marketing agency headquartered in Toronto, Canada. Founded in 2005 by Neil Follett, Brightworks serves marquee clients across diverse sectors, with deep expertise across pharma and healthcare.

The Win-Win

The Transaction enables Brightworks to continue its next phase of growth as part of a market leading agency. Canadian Business Growth Fund provided financial support. Neil Follett will lead Believeco as its CEO and will play an integral role in combined business going forward.
Some of our recent deals include:

- **believeco**: Has been acquired by BRIGHTWORKS

- **VWestcap**: WBM Technologies Inc. has received an equity investment from CenterGate CAPITAL

- **SOROC**: has received an investment from SOROC Solutions

- **Vistavu**: has acquired achieveit SOLUTIONS

- **abils**: has acquired Passerelle

- **SIAPARTNERS**: EY advised on an acquisition that created one of the largest IT Services companies in Quebec.

- **DIGITCOM**: atlantic telecom has acquired an interest in

- **Well.ca**: has been acquired by McKesson Canada
Video Series

Programmed for Success

EY’s Technology M&A practice has recently launched a new video series, Programmed for Success.

The 5-part series hosted by EY’s Canadian Technology M&A Leader, Sid Nair interviews industry thought leaders from inside and outside of the firm. The series focuses on key considerations, risks and opportunities that should be considered prior to a sale of a technology business.

Watch along as Sid Nair explores the key considerations when selling your technology business with industry thought leaders.

Watch Episodes 1 - 5

Join the conversation #BetterWorkingWorld
Dec 22, 2022: Tata Communications (Netherlands) B.V. announced the acquisition of The Switch Enterprises, LLC, a global end-to-end live video production and transmission services provider, for a transaction value of $58.8 million. The transaction represents an enterprise value of 0.7x revenue.

Dec 15, 2022: GoLogiq, Inc. (OTCPK: GOLQ) announced the acquisition of GammaRey, Inc., a global financial technology company, building a financial ecosystem and platform to provide financial solutions to government, business, and consumers, for a transaction value of $320.0 million.

Dec 14, 2022: Xobee Networks acquired Myers Network Solutions, Inc., which offers outsourced managed IT services and computer business solutions, for a transaction value of $1.7 million.

Dec 08, 2022: DLH Holdings Corp. (NasdaqCM: DLHC) acquired Grove Resource Solutions, Inc., a provider of cloud-based enterprise modernization and cyber security solutions to civilian and military federal agencies, for an approximate transaction value of $185.0 million.

Dec 07, 2022: HGS CX Technologies Inc. announced the acquisition of Teklink International Inc., a full-service financial planning and analytics service provider, including design, implementation, and application management services, for a transaction value of $58.8 million. The transaction represents an enterprise value of 2.7x revenue.

Dec 01, 2022: Harte Hanks, Inc. (NasdaqGM: HHS) acquired substantially all the assets of Inside Out Solutions LLC, which operates as a sales enablement agency that offers technology and data driven support to various sectors, for a transaction value of $7.5 million.

Nov 22, 2022: MCI Capital acquired a stake in Startek, Inc., a business process outsourcing company which provides customer experience, digital transformation, and technology services in various markets, for a transaction value of $16.8 million. The transaction represents an enterprise value of 0.6x revenue and 4.4x EBITDA.

Nov 22, 2022: Western Acquisition Ventures Corp. (Nasdaq: WAVS) announced a merger with Cycurion, Inc., a provider of tech-enabled cybersecurity solutions, in a SPAC deal at a pro-forma enterprise value of $170.4 million.

Nov 15, 2022: OCN Co. Ltd. acquired Merchant e-Solutions, Inc., a provider of cloud-based commerce platform that provides payment processing and solutions to businesses, for a transaction value of $359.0 million.

Nov 04, 2022: NIIT (USA), Inc. acquired St. Charles Consulting Group LLC, which offers solutions in four key areas - strategic consulting, custom learning experiences, learning curation, and managed services, for a transaction value of $23.4 million.

Nov 04, 2022*: 14487460 Canada Inc. acquired Tel Distributed Information Technologies Inc., provides scalable blockchain infrastructure and transactional platforms to support businesses building solutions and applications, for a transaction value of $25.9 million. The transaction represents an enterprise value of 1.3x revenue.

Nov 01, 2022: Cognizant Technology Solutions Corporation (NasdaqGS: CTSH) announced the acquisition of professional services and application management practices of OneSource Virtual, Inc., for a transaction value of $120.0 million.

Oct 27, 2022: KKR & Co. Inc. (NYSE: KKR) announced the acquisition of Ness Technologies Inc., a provider of end-to-end digital transformation services that include cloud engineering, data and analytics, experience design, intelligence engineering, and salesforce for businesses, for a transaction value of $500.0 million.

Oct 26, 2022: CentralNic Group Plc (AIM: CNIC) acquired Intellectual Property Management Company, Inc., a provider of subscription-based corporate domain management services to enterprises, for a transaction value of $7.6 million. The transaction represents an enterprise value of 2.8x revenue and 7.0x EBITDA.

Oct 25, 2022*: 1377900 BC Ltd. acquired consulting & exploration tech division of EarthLabs Inc, which comprises of exploration consulting and technology services business, for an approximate transaction value of $22.0 million.

Oct 21, 2022: Crexendo Inc. (NASDAQ: CXDO) acquired Allegiant Networks, LLC, a telecom, and data services company offering unified communication as a service, telecom services, managed services, and network services, for a transaction value of $9.3 million.

Oct 11, 2022: Perficient, Inc. (NasdaqGS: PRFT) acquired Anexis Technologies Corp., which operates as a digital experience consultancy providing CMS services, including episerver services, ektron services, kentico services, sharepoint, and sitecore and open-source services, for a transaction value of $38.0 million. The transaction represents an enterprise value of 2.0x revenue.

Oct 11, 2022*: Jasper Commerce Inc. (TSXV: JPIM) announced the acquisition of Cartika Internet Solutions Provider Inc., a full-service IT infrastructure provider specializing in managed cloud and IaaS support, for an approximate transaction value of $1.9 million. The transaction represents an enterprise value of 1.7x revenue and 19.9x EBITDA.

Oct 05, 2022*: PS Commerce, Inc. (NasdaqGS: SPSC) acquired InterTrade Systems, Inc., provides B2B solutions to address supply chain challenges and associated electronic data interchange needs, for an approximate transaction value of $49.0 million.

Oct 04, 2022: 13 Verticals, Inc. (NasdaqGS: IIIV) acquired Celtic Cross Holdings, Inc., a provider of enterprise software solutions for the motor carrier and motor vehicle markets in the US and Canada, for a transaction value of $85.0 million.

Oct 03, 2022: RafterOne, a global provider of multi-cloud commerce solutions on the Salesforce platform, for an approximate transaction value of $241.2 million.
Historical M&A activity

Both deal values and deal volumes have declined compared to Q4 2021 levels, but saw a rise compared to previous quarters.

Deal value by type of acquirer

Public company multiples remain volatile throughout the year 2022, subsequent to the highs observed in early 2021.

Revenue transaction multiples for CHS, DPOS and IS&I declined compared to Q4 2021.

EBITDA transaction multiples mostly declined in Q4 2022 compared to Q4 2021.

* Sample size for M&A deal multiples has been sourced from S&P Capital IQ and comprises transactions completed between Oct 1, 2018 and Dec 31, 2022 in Canada and the US. The sample has been compiled by EY Orenda Corporate Finance Inc. based on a subjective assessment of transactions in the IT Services sector. Furthermore, the categorization of the sample across various sub-sectors and any analysis thereof, by EY Orenda Corporate Finance Inc. is solely for illustrative purposes and was not created to serve as benchmarks. Every transaction has specific characteristics that impact value and corresponding multiples. It is necessary to understand the background and circumstances surrounding each transaction to extract meaningful insights.
Our Deal Team

National Leader

Barry Munro *
+1 403 206 5017
barry.g.munro@ca.ey.com

Ontario

Andrew Schafer
+1 416 932 6244
andrew.schafer@ca.ey.com

Chris Hutchinson *
+1 416 932 6002
chris.hutchinson@ca.ey.com

Sid Nair
+1 416 943 3404
sid.nair@ca.ey.com

National TMT team

Sid Nair
Canada TMT M&A Leader, Senior Vice President
+1 416 943 3404
sid.nair@ca.ey.com

Quebec

Ken Brooks *
+1 514 874 4412
ken.brooks@ca.ey.com

Todd Caluori *
+1 514 879 2793
todd.m.caluori@ca.ey.com

Kevin Casey *
+1 519 571 3311
kevin.j.casey@ca.ey.com

Atlantic

Michael Lutes
+1 416 943 2699
michael.j.lutes@ey.com

Sid Nair
+1 416 943 3404
sid.nair@ca.ey.com

Western Canada

Barry Munro *
+1 403 206 5017
barry.g.munro@ca.ey.com

Darcy Yamada
+1 780 441 2456
darcy.yamada@ca.ey.com

Logan Day
+1 780 441 4226
logan.s.day@ca.ey.com

Brock McMillan *
+1 403 206 5335
brock.mcmillan@ca.ey.com

Bill Wu
+1 416 943 2546
bill.wu@ca.ey.com

Ujjwal Bhati
Senior Associate
+1 604 891 8325
ujjwal.bhati@ca.ey.com

Jack Quaglia
Analyst
+1 416 932 4495
jack.quaglia@ca.ey.com

Barkin Sayiner
+1 416 932 6244
barkin.sayiner@ca.ey.com

Roger Leslie
+1 416 347 0367
roger.t.leslie@ca.ey.com

Logan Day
+1 780 441 4226
logan.s.day@ca.ey.com

Mike Campbell
+1 306 649 8305
mike.campbell@ca.ey.com

* A registered Exempt Market Dealing Representative

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young Dendra Corporate Finance Inc., is registered as an exempt market dealer in Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, Ontario, Quebec and Saskatchewan.

© 2023 Ernst & Young LLP. All Rights Reserved. A member firm of Ernst & Young Global Limited.

4059037

ED Note

This publication contains information in summary form, current as of the date of publication, and is intended for general guidance only. It should not be regarded as comprehensive or a substitute for professional advice. Before taking any particular course of action, contact Ernst & Young or another professional advisor to discuss these matters in the context of your particular circumstances. We accept no responsibility for any loss or damage occasioned by your reliance on information contained in this publication.

ey.com/en_ca/strategy-transactions