Why You Need to Diversify Your Customer Base

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We've all heard the saying, "Don't put all your eggs in one basket." It is often quoted when discussing the importance of diversifying an investment portfolio so it isn't vulnerable to wild price fluctuations by just one or a handful of stocks.

This saying is also appropriate when it comes to diversifying your customer base. In the same way that your investment portfolio can suffer great losses if it contains too few different securities, your business can suffer great losses if you have too few customers. In this situation, if you were to lose a large customer upon which your business is heavily dependent, the very survival of your company could be threatened.

How Big Is Too Big?

So just how big of a customer is too big of a customer? It's generally advisable that no single customer account for more than 20 percent of a company's total revenue. This figure is probably a little bit high — ideally, no customer should account for even 10-15 percent of your total revenue if you want to really be safe from customer concentration risk.

For example, consider a manufacturing company that recently landed a large contract with a big box retailer. Of course, the salesperson and owner are extremely excited about this big new client and the additional revenue. However, this client will now account for 50 percent of the company's revenue — an extremely high customer concentration. While it wouldn't be wise for the company turn down the business due to concentration risk, the owner needs to be aware of this risk and plan the company's finances accordingly.

There are a number of drawbacks to a heavy customer concentration, including the following:

- The biggest drawback is the huge financial hit your company will take if you lose this large customer. In a worst-case scenario, this hit could be lethal to your business. Even if it isn't, it could result in defaults on lender covenants and disagreements and conflicts with your investors.

- Due to this financial hit, you will likely have to reduce spending on things like marketing and human resources, which can inhibit your ability to grow the business.

- The financial hit will also probably have a significant impact on your cash flow, which could affect your ability to pay your vendors — and maybe even your employees — on time.

Here's another drawback that's not as obvious: You might end up tying your business so closely to a major customer that you modify your processes, products and services to meet that customer's requirements to the detriment of your other customers. For example, you might end up changing your hiring and training practices and your marketing strategy. In this scenario, you can almost become a "division" of your large customer and make changes to your core business that do not complement or benefit your other customers.

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How to Lessen Concentration Risk

To lessen your customer concentration risk, you should strive to balance out your customer base so that no single customer accounts for more than 10-15 percent of your total revenue. Similarly, no small cluster of clients (such as two or three) should account for more than 40-50 percent of your revenue.

Balancing out your customer base is not something you can do overnight. Obviously, you would probably never turn down a large new client because they increase your customer concentration risk. The key is to try to land more new small customers who combined can help offset the potential loss of the revenue of the large customer if they depart. It's also a good idea to try to diversify and expand into new products, markets and regions.

Diversifying your customer base can lead to many benefits for your business, including the following:

- The biggest benefit is the financial security and peace of mind that come with not having to worry about the loss of one large customer wiping out your business.

- Minimizing customer concentration risk may increase in the value of your business. Most buyers tend to shy away from companies with heavy customer concentrations. Conversely, they may pay a premium for companies whose customer base is well-diversified.

- You will optimize your company's revenue through growth in new customer segments and markets. In addition, you could maximize opportunities to sell new products and services to both new and existing customers.

An outsourced CFO services provider can help you reduce customer concentration risk by first evaluating your customer base to determine your current level of concentration and financial risk. The outsourced CFO will then provide guidance to your business development efforts with regard to targeting prospects who can help balance out your customer base. He or she will also perform a financial analysis by reviewing data related to your large customer(s) to determine possible cash flow problems that could arise from the loss of such customers.

Concluding Thoughts

In the same way that your investment portfolio can suffer great losses if it contains too few different securities, your business can suffer great losses if you have too few customers. If you were to lose a large customer upon which your business is heavily dependent, the very survival of your company could be threatened. To lessen your customer concentration risk, no single customer should account for more than 10-15 percent of your total revenue. An outsourced CFO services firm can help you reduce customer concentration risk.

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