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Analyzing Suppliers From a Transaction Perspective

Identifying potential issues can enhance the prospects of a sale.

by Jay Schembs

Suppliers are the lifeblood of nearly all businesses. Particularly for manufacturers and distributors, unique supplier relationships enable businesses to generate superior returns. In that vein, the loss of an important supplier can have a crippling effect on a business. Michael Porter's "Five Forces" delves deeply into suppliers as an integral component of competitive advantage, and our intent is not to rehash his writing. Instead, this article analyzes supplier relationships within the context of a capital markets transaction – whether that's a sale, minority equity investment, or debt financing. In each instance, the investors' due diligence processes will closely scrutinize supplier composition and relationships. Identifying and addressing potential issues or roadblocks in supplier relationships can greatly improve the outcome of a transaction.

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We believe there are four major categories of risk related to suppliers: concentrated supplier base, lack of backup for critical inputs, contractual terms that affect assignment to a new owner, and supplier power. Each of these categories can drive away otherwise interested buyers, derail, or delay the desired transaction.

Although these risks are real, each transaction is unique. For example, a strategic buyer may be seeking an acquisition specifically because of a supplier relationship. In other instances, heavy exposure to one supplier may help reduce an acquirer's reliance on its own supply network. For most private equity buyers, however, there are few circumstances that can turn these dynamics into positives. In fact, some risks are perceived to be so significant that a private equity buyer will not even consider an acquisition, limiting the potential buyer universe. It is prudent for the business owner to recognize these risks and attempt to mitigate the potential negative consequences for the benefit of the business and the transaction.

1. CONCENTRATED SUPPLIER BASE

A concentrated supplier base exposes a business to the conditions and vagaries of the specific supplier. A supplier's own business or financing decisions are often not completely known and that company's financial and liquidity situation could impact its ability to perform. During the Great Recession, Chinese seafood processing businesses became credit constrained and could no longer finance inventory purchases, thereby leaving US retail customers short on expected product, as well as causing Alaska seafood processors issues by interrupting their revenue streams. Suppliers are businesses as well and may have different priorities for different customers. If the business relationship is not important enough for the supplier, the business will be at risk for other supplier customers inserting their own priorities. If the supplier is unable to deliver according to the time and quality standards expected, the business may experience serious problems.

Vetting, training, and negotiating new supplier relationships take time. A buyer will reasonably want to understand the supplier dynamics and the path to mitigating that risk through expanded supplier relationships.

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2. NO BACKUP FOR CRITICAL INPUTS

A potentially even greater risk is when the supplier is unique. If because of specific product characteristics (e.g., recipe, patented process, or restricted access to a market), interruption to supply can be lethal, the only solution will be a substitute input that could materially change the nature of the business's cost structure and product profile. This is often a more difficult risk to uncover, since certain "critical" inputs may comprise a negligible portion of a company's costs. Sellers should expect that any strategic or financial buyer is sophisticated enough to identify critical inputs during due diligence. Even if the current owners are willing to live with this risk, it should not be expected that a new owner will feel the same. A backup plan is essential.

3. ONEROUS CONTRACTS

Contractual arrangements with suppliers are a double-edged sword. On the one hand, they (usually) clearly define the relationship, removing ambiguity as to what is expected or required from the other party. On the other hand, contractually obligating the business to something like minimum purchase volumes reduces flexibility and optionality. Further, many contracts contain change of control provisions that grant a supplier (often a landlord) negotiating leverage at an inopportune time. Many a deal has been delayed by the inability to track down the landlord on a weekend to get his or her consent to satisfy a final closing condition. When negotiating supplier contracts, owners are wise to be cognizant of a contract's potential impact on a future transaction.

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4. UNDUE INFLUENCE OVER TRANSACTION

One of the more obscure but significant risks in certain supplier relationships is the right of first refusal ("ROFR"). Certain industries rely on symbiotic relationships between manufacturers and distributors, where the customer has direct and recurring exposure to

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both. For example, the auto dealership model exposes customers to both the dealer – with whom they interact for initial sales and often follow-on service and warranty work – and the OEM, whose product they are buying. The OEM worries their brand could be at risk with a dealer unable to effectively service the end customer or who may be inadequately capitalized to respond to the OEM's demands for facility growth and technology upgrades. Because of these concerns, such agreements often contain ROFRs granting the OEM the ability to step into an executed sale agreement, if they are concerned about the new buyer. In some cases, the OEM supplier may require absolute unconditional approval of the buyer or even the right to select the buyer. We have completed numerous transactions in these situations and are well aware of the uncertainty and added time/expense such complications present. In these instances, creating an open dialogue with the OEM such that a seller has a clear understanding of an OEM's expectations can greatly assist in a sale process.

As most owners are painfully aware, supplier relationships are of vital importance to a business. These relationships, cultivated over years or decades, provide access to inputs of products that help a company serve its customer base. Often this access provides differentiating characteristics enabling extraordinary economic returns. While the risks outlined above may seem innocuous on a day-to-day basis to most owners, mitigating them can materially improve the terms and conditions in a debt or equity transaction. **ZS**

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