Sextant Consulting Pty Ltd

Article 5: Governing the Targeting Stage

This is the fifth and final article in a quintet of articles on board governance of M&A, published by the AICD Governance Leadership Centre.

Some words from the wise

"If you don't know where you're going, you might not get there" [Yogi Berra]

By way of a brief recap, the full M&A lifecycle can be divided into the following four stages:

1. Targeting (including development of the M&A intent and strategy)
2. Transaction (the deal)
3. Transition (post-deal, or the first 100–180 days)
4. Transformation of the combined enterprise.

The series of articles has been written in reverse order – starting with the end in mind.

In the beginning….

This final article deals with the **Targeting** stage, which is all about ensuring that there is a clear rationale and strategy upfront for commencing with any acquisition process. Here, the board's role is that of active participant and co-owner in shaping the M&A strategy with management, without co-opting its independence or ability to provide the necessary challenge to management's strategic thinking. It is in this first stage that the foundation should be established for the company to approach M&A with deliberateness, as opposed to drift.

Why is this stage so important?

The Targeting stage sets the scene for a whole range of consequences – intended and unintended. The worst outcome from not doing this stage well, or at all, is that it can lead you into a deal you should have never pursued. Poorly performed, it will cause you to waste time, executive attention and money chasing after spurious deals or tilting at windmills. But if well-executed, this stage will help you build a target list of interesting potential acquisitions, with a well-founded M&A rationale for *why* acquisitive growth is important, *what* specifically you are interested in, *where* you will look and *when* (how soon). Crucially, this will also form the foundation for good alignment between board and management for what follows.

This stage may not be where the deal value is lost or won – as is the case with the Transaction stage – but it is the stage where the foundations for M&A success are set.

This stage goes to the heart of two of the key themes emerging from my research and discussed in earlier articles, namely:

(1) the Board's degree of strategic thinking (*'Clear strategy upfront'); and*
(2) planning and preparation (*'Early preparation and planning'*).

What typically goes wrong?

The first failure is that often this stage does not really occur or is bypassed entirely. In other words, the CEO or Managing Director presents an acquisition opportunity to the board with little preamble. Equally damaging, if not more so, is where the board foists a potential acquisition on to management. This means the M&A strategy (targeting stage) is a non-event, and a range of key strategic topics and questions that board and management should really discuss in depth never get properly aired. Some examples of key questions that the board and management should address together are included in the table on the following page.

Targeting Stage

Tips and Traps

What to do right: conditions for success

1. Clear M&A strategy
2. Agreed selection and evaluation criteria
3. Well managed deal pipeline with active stage gate management
4. Broad alignment on the strategic outcome i.e. "where and why"

What to look out for

5. Opportunism and surprises
6. Advisers bearing gifts – dreaded temptations
7. FOMO ("Fear of Missing Out") and the lemming effect – competitor moves triggering knee jerk reactions
8. Lack of ownership by management team

Remember:

9. This is a marathon, not a sprint
10. Preparation and analysis ideally needs to commence years before triggering action

Do not pass 'Go' without addressing these topics with management

- What has really been driving our historic growth? How likely are these factors to continue?
- What will it take to outperform market expectations and how much should we boost this growth via acquisition?
- If non-organic growth is the preferred way to go, what level of shareholder value creation do we want to derive from acquisitions?
- What level of investment would we be able safely to tolerate? How would we fund it? What will we have to stop doing / investing in if the acquisition is successful?
- What is the primary purpose: asset or cost-efficiencies? Scope? Skills? Scale? New capabilities?
- What are the specific parts of our value chain we need to grow in this way? What do the associated industry profit pools look like? Which market/customer segments? Which geographies? Why these and not others?
- What are our target evaluation criteria? What are our non-negotiables? What are the characteristics of a perfect target?

The second failure is that if the deal is already on the table – especially if it is the only one being presented – it causes the board and executive to go into 'end game' mode; that is, how do we make this one work? When this happens, the converse question is far less likely to be posed, namely, what do we need to prove to ourselves to know why and when we should walk away? Coupled with loss aversion, the deal gets pitched as being a must-do or being "strategic".

A third common failure is the converse of the former; namely, that in the absence of deal criteria or a deal management pipeline, there are no objective ways to filter or cull potential transactions, and management is pinned down sometimes by a range of potential red-herring target opportunities.

As one board member and former corporate executive said when being interviewed as part of my research:

"So if you don't have that (a strategy) then …you can end up stumbling from one deal to another. And maybe some companies are lucky, they just stumble across a deal and that determines their strategy but it's not the way to do it."

Harding and Rovit, two directors of Bain and Co,[1] have said that:

"…deal making is an extension of a company's business policy, or strategy. Before a company can form a valid opinion of a potential deal, it needs to assess whether an acquisition will further its growth strategy. The decision to acquire must demonstrate that it will strengthen the firm's overall business portfolio… Making mergers work is inseparable from strategy. You need to have an investment thesis in order to make a strong acquisition."

[1] Bain & Co., *Mastering the Merger*, 2004, by David Harding and Sam Rovit at pg. 9

So what are the key things boards should be looking out for in this stage?

The first warning sign for a board is that management lacks a clear and actionable strategy that justifies, informs and guides M&A activity – and thus precedes any possible transaction.

The board's co-ownership of strategy

As another interviewee put it:

"So the custodians of the strategic clarity I think is the board. The three functions of the board in my mind are the overall governance of the organisation, the strategy, and making sure we've got the best CEO that's possible for the business….but…the board can't walk away from saying 'well the CEO saw an opportunity, it was cheap so we thought we'd buy it, but …it makes no strategic sense whatsoever'".

As another director put it, the foremost question is:

"Well the main thing is does it align with strategy? I mean hopefully you don't just fall into a transaction, …I know transactions are opportunistic and they do come up quickly, but the planning process should be starting two to three years' prior in terms of where the company wants to go…".

A seasoned chairman explained it in these terms:

"I think that there are a number of very important indicators for what would really be a successful transaction. The first is that the board is not surprised by it. ….they watch it, that they nurture it… then they spring and then they do it. …there is a PhD in a thesis of those who were opportunistic and quickly dived in versus those who have watched over time and I would lay almost pounds to peanuts that the ones who do it over time are the better deals."

The second key lookout for boards is that the deal evaluation criteria are not clear and have not been agreed between them and the management team; and the negotiable as well as non-negotiable factors have not been outlined. For example, does a deal always need to exceed a certain hurdle rate and, if so, over what period? At what pre-agreed point do we walk away? Or are we going to be governed by FOMO ("Fear of Missing Out")?

The third key lookout is that a preliminary philosophy on how we will approach acquisitions has not been tabled. For example: will we always want to integrate and what does that mean? What guides that decision? Or do we adopt a horses-for-courses approach? Will we use investment bankers or other deal advisers and if so, who and on what commercial basis? To what extent will we build real in-house capability amongst our executive team to manage and execute the deal across its lifecycle? Will we use cash and/or scrip to make acquisitions?

Not addressing such questions will mean that, of necessity, the management team needs to make it up as they go along; or that they do not face these questions until they suddenly become crucial and the board demands answers. Worse still, is that no one thinks of answering these sorts of questions until after the deal is done, or until board and executive are at loggerheads over these approach matters in the swirl of the transaction. If the likelihood of a transaction does suddenly accelerate, there usually is not adequate time for clear thinking and debate to ensure that the board and management team are on the same page.

A concluding comment on targeting from an interviewee

"....I don't know that I've ever seen....a great transaction which has been done overnight in an area that the company hasn't been contemplating, ...generally those deals have .... spelled the end of a company."

Test yourself with five key moment-of-truth questions

In being prepared at the Targeting stage, *ask yourself five critical questions* on how you and your fellow board members govern the M&A strategy being developed**:**

1.	Do all executives and senior management have a compelling and consistent view on why M&A is crucial to our strategy and what the selection criteria or factors are for evaluating future targets?	✓
2.	Are we in touch with what our key stakeholders expect of us and whether our M&A ambitions will meet or exacerbate their concerns?	✓
3.	Do we have an informed view of what existing or new competitive capabilities we hope to enhance via acquisitions?	✓
4.	Is management clear-eyed on what organisational capabilities (i.e. processes, systems, skills, behaviours) they will need to be successful with a future M&A program and how to address key gaps?	✓
5.	What are the key assumptions, unknowns and potential 'game changing' developments that could derail our strategies and plans? Who will be monitoring and managing these?	✓

Want to see how you perform?

To see how you score relative to members of other boards answering the same questions, please follow the link below to take a quick survey. Your results will be emailed to you. All information is de-identified so no one will know how others have scored their performance or who any of the other respondents are.

https://www.surveymonkey.com/r/JKDM7XZ

If for any reason the link is not operating, please contact me at:
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Thank you