L.E.K.

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# Screening for Success: Designing and Implementing a Strategic M&A Screening Process

Developing a screening process for M&A targets is a critical step in the execution of an effective M&A strategy. A proactive, structured screening process helps organizations accurately assess the best targets that can advance corporate business strategies.

Applying a formal screening methodology, like the one L.E.K. employs with its clients, involves developing clear inclusion/exclusion and prioritization criteria, building a comprehensive candidate list, applying the criteria to narrow the scope of potential targets and producing in-depth candidate profiles to enable a more informed approach and support the initial due diligence stage.

In addition to greater overall M&A success, which can result in increased shareholder value, other key benefits include:

- Enhanced strategic consistency
- Opportunity prioritization
- Effective use of limited resources
- Reduced influence of politics
- A framework for ongoing analysis

These benefits serve as powerful reasons to undertake a proactive and systematic M&A screening process.

## Introduction

Merger and acquisition (M&A) activity is often a critical component of growth and diversification. In consulting with a broad range of companies throughout the M&A process, L.E.K. Consulting has found that many organizations do not have a systematic screening process in place to ensure that their M&A efforts support their corporate growth strategies.

Potential deals are often initiated informally, via a telephone call or a personal conversation with an investment banker, a business broker, or a business development executive at another firm. This approach to identifying opportunities is frequently paired with a screening process that can be best described as "ad-hoc," in which screening criteria are informal or undefined and are applied inconsistently to potential opportunities. Not surprisingly, this can result in sub-optimal outcomes. Companies and products that do not have a good fit with the overall corporate strategy may be considered, and due diligence may be undertaken – all drawing on limited resources. Furthermore, when sub-par opportunities are considered, management time may be wasted and unnecessary costs incurred. While time and resources are devoted to these potentially less valuable opportunities, the "right" deal may go unexamined.

On the other hand, a proactive, systematic approach to the M&A process, including a well-defined screening stage, creates substantially greater potential for success. An orderly, comprehensive screening process arms organizations with a structured methodology that enables fast, effective responses to sound opportunities – and supports more effective research to find even better ones. Whether for in-licensing products, acquiring companies, or seeking a merger partner, a proactive screening process is a crucial step in the M&A process.

*Screening for Success: Designing and Implementing a Strategic M&A Screening Process* was written by **Steven Rosner**, Vice President in L.E.K.'s Boston office. Please contact L.E.K. at strategy@lek.com for additional information.

**Exhibit 1**

The M&A Process


As Exhibit 1 illustrates, the overall M&A process has several major stages. Acquisition screening immediately follows the first stage of strategy development and sets the foundation for the rest of the process. Consequently, designing and implementing a well-thought-out approach positively impacts every subsequent stage.

In this issue of *Executive Insights* we discuss in detail the benefits of utilizing a systematic approach to screening M&A opportunities and share identified best practices that can be applied as companies seek to improve their success rates in M&A, product acquisition, in-licensing and other types of deals. Those companies that rigorously engage this type of proactive screening process are positioning themselves to be competitive in both the short and long terms as well as increasing the likelihood that their efforts will improve shareholder value.

## The Benefits of a Proactive M&A Screening Process

Organizations that adopt a proactive M&A screening process have an advantage over companies that target their acquisition prospects using the common "over-the-transom" approach, in which M&A researchers may only consider companies that have made it clear that they are in the market.

L.E.K has identified five key benefits that a company can derive from a formal and more proactive approach to the M&A process:

**1. Enhanced strategic consistency**

M&A activity is often a critical component of corporate strategy. Companies that use a systematic and proactive screening process know that their business development activities are targeted at opportunities that help fulfill the strategy of the business. Similarly, if an "over-the-transom" opportunity arises, management can quickly and efficiently assess it and move forward if appropriate.

**2. Most attractive deals targeted first**

Developing a proactive approach enables a company to target the most attractive companies or products first, increasing the overall likelihood of deal success and minimizing time and effort wasted on less optimal opportunities. Furthermore, a competitor may learn of an impending deal and actively respond. By approaching the screening process proactively, a company can establish and maintain a competitive position by being first to engage, by being more informed, and by being prepared to move on a deal more quickly.

**3. Efficient use of limited resources**

The time that executives spend on suboptimal opportunities prevents them from focusing their attention on other, possibly more valuable, opportunities. Ensuring resources are consistently focused on the highest-priority opportunities maximizes the return on a company's time and efforts.

**4. Reduced politics**

When taking the "over-the-transom" approach to opportunity assessment, personal and professional relationships and individual preferences for given deals can strongly influence how opportunities are viewed and internally promoted. This can lead to bias and politics, both of which may serve to complicate the process and undermine strategic objectives.

Adopting a proactive approach to acquisition screening – one that is driven by strategic goals, a comprehensive list of opportunities and clear screening criteria – can significantly reduce bias and help the process proceed with minimal politics.

**Adopting a Proactive M&A Screening Process Provides Five Key Benefits**

- Enhanced strategic consistency
- Opportunity prioritization
- Effective use of limited resources
- Reduced influence of politics
- A framework for ongoing analysis

**5. A framework for ongoing analysis**. Keeping track of multiple opportunities is both critical and challenging. Utilizing a formal screening process can assist companies in maintaining a clear paper trail of the decision-making process, helping business leaders keep track of why companies have been included or excluded over time and enabling ongoing analysis as opportunities and circumstances develop.

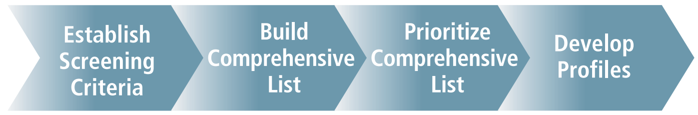
A framework or system to manage this flow of information may, in fact, become the most important single resource in a business development program, particularly if it is maintained as a "living"system that is regularly updated to reflect ongoing changes in the marketplace. This framework may be as formal as a database or as basic and informal as a key individual who mentally organizes, manages and communicates essential information.

## Understanding the Components of an Effective M&A Screening Strategy

There are four essential steps in the M&A acquisition screening process, which are summarized in Exhibit 2. In this section we outline each of the four steps, followed by examples of how companies have successfully implemented this process as part of their overall M&A strategies.

**Exhibit 2**

The Screening Process




### Step 1 – Establish and Define Screening Criteria

A well-designed M&A strategy clearly articulates the organization's goals and highlights the factors that make an opportunity attractive. This in turn drives the development of the most appropriate set of screening criteria. As research is conducted and opportunities are assessed, more details can be added to clarify and refine the criteria necessary to fulfill the M&A strategy. Components of a company's business strategy that might drive screening criteria include:

- *"If a strategy involves leveraging an existing sales force,what new products are optimal?"*
- *"If a strategy requires entering a new market segment,which segments are most attractive and what companies can help enter these segments?"*
- *"If a strategy calls for low-cost manufacturing capability, which companies can provide it?"*

With strategic objectives in place, the organization can develop a set of clear criteria to evaluate deal opportunities. The criteria used to judge M&A opportunities will typically fall into one of three categories: ***inclusion, exclusion,*** or ***prioritization*** criteria.

Inclusion and exclusion criteria are relatively straightforward. They apply specific elements from the corporate strategy to quickly include or exclude prospective companies without expending a significant amount of resources. This is especially important when an organization is evaluating a long list of companies. In general, L.E.K. has found that 50% to 80% of prospects can be excluded early in the evaluation stage by employing inclusion or exclusion criteria. Some examples include:

- **Geographic Criteria –** *"We are looking to acquire businesses that have U.S.-based headquarters and 90% or more of their sales within the continental U.S."*
- **Product or Customer Criteria –** *"We want to acquire currently marketed pharmaceutical products that can be prescribed by a cardiologist."*
- **Size Criteria –** *"Only companies that have revenues greater than $20 million will be considered as part of our evaluation."*
- **Capabilities Criteria –** "We are looking for companies that can provide us with low-cost manufacturing capabilities in China."

Prioritization criteria, on the other hand, require a different type of judgment because a range of options may need to be considered as part of the acquisition opportunity. Examples might include prioritization by:

- **Time or Date –** *"Ten years of patent protection is better than five, but how much better?"*
- **Size –** *"$100 to $500 million in sales is best, but $50 million to $100 million is sufficient."*
- **Product Position –** *"The leading brand in the target segment may be best, but the product in the number two share position will also be attractive."*

### Step 2 – Build a Comprehensive Candidate List

The second step in the process is to build a comprehensive list of companies from which to begin the screening process. The size and scope of this list depends primarily on the company's particular industry, strategic intent and how rigid the acquisition criteria are.

The initial list should be assembled from multiple sources, such as SIC codes, industry databases, trade associations, mailing lists and industry journals. Casting a wide net to gather a range of potential prospects has distinct benefits. Pulling information from diverse sources reduces the probability that a favorable candidate will be overlooked. In addition, when multiple or conflicting opinions exist, a more comprehensive list facilitates consensus-building and results in more objective decisions.

Once a comprehensive list has been created, a system can be built to store key data on an ongoing basis, such as which companies have been included or excluded for consideration and why. This provides a valuable tool that can be updated over time as the business situation changes for the enterprise and the prospective targets. If a company decides to change its geographic inclusion criteria, for example, sorting through companies with a significant European operation, while excluding those that are headquartered outside the U.S., could be accomplished quickly and efficiently.

### Step 3 – Prioritize Comprehensive List

Inclusion and exclusion criteria can now be applied to the comprehensive list, quickly and efficiently eliminating those opportunities that do not meet the basic threshold for inclusion and identifying those that should be considered for further assessment.

Once the list has been truncated, additional data can be collected and the prioritization criteria applied to the remaining companies. Data may come from secondary sources such as SEC filings, articles, corporate websites or market research reports. Primary research, such as contacting the company, speaking to sales representatives, or interviewing established customers, may also be necessary at this point.

Some clients with whom L.E.K. has worked utilize a numerical rating system. For example,a company at the ideal size of $100-$500 million in revenues might be given 10 points. A company with a slightly less attractive size of $50-$100 million in revenues might be given 5 points. Adding up the points across all the criteria allows for prioritization of the opportunities.

An alternative approach is to allocate weightings to each criterion. For example, management talent might be rated a 10, but revenue might be rated a 5. The score in each prioritization category is then multiplied by the weighting and the total for each candidate summed.

Some companies prefer to perform this assessment stage on a more qualitative basis, without formally quantifying the criteria.

### Step 4 – Develop Profiles

Once the final list of potential targets has been refined, it is critical to develop a profile representing each of the candidates. These profiles can range from a page to several pages in length depending on the needs of the company. Some aspects of these profiles may include:

- Key company information such as size, location(s) and organizational structure
- Background and contact information on target company decision makers
- Management team background
- Ownership structure
- Company or product history
- Product and patent information
- Customer and market data
- Current business alliances
- Competitive situation
- Segment trends

With these profiles in hand, decision makers have enough information to make an initial approach to an M&A target. While profiles should not be considered sufficient due diligence to move forward with a transaction, they do provide a good summary to begin the process.[1]

The following case studies illustrate how two L.E.K. clients have used this process to facilitate and hone their M&A strategies. While their industries are vastly different, they were able to apply the same methodology and process to help achieve their overall corporate and M&A goals.

**Case Study: A Biopharmaceutical Company Employs M&A Screening to Identify New Products for In-Licensing**

L.E.K. worked with a biopharmaceutical company that used the proactive acquisition screening process described here to identify new products for in-licensing. At the time, the company had one successful product on the market and employed an underutilized sales force. The company's executive team embarked on an in-licensing strategy to search for products that met the following inclusion/exclusion criteria:

1. Established in specific therapeutic areas, such as the cardiovascular or respiratory segments
2. Primarily focused on the U.S. market
3. Sales potential of $500 million

As a further refinement to the basic inclusion/exclusion criteria, the company wanted to target products that had not been approved by the Food and Drug Administration (FDA) but were far enough along in clinical trials that a product launch would be possible within the next two years.

To prioritize the products, additional criteria were applied. For example, were the target products in certain segments of the therapeutic area? If so, which ones? How long was the patent life on the products? Were the types of doctors predominantly primary care physicians or specialists? What was the level of differentiation for each product?

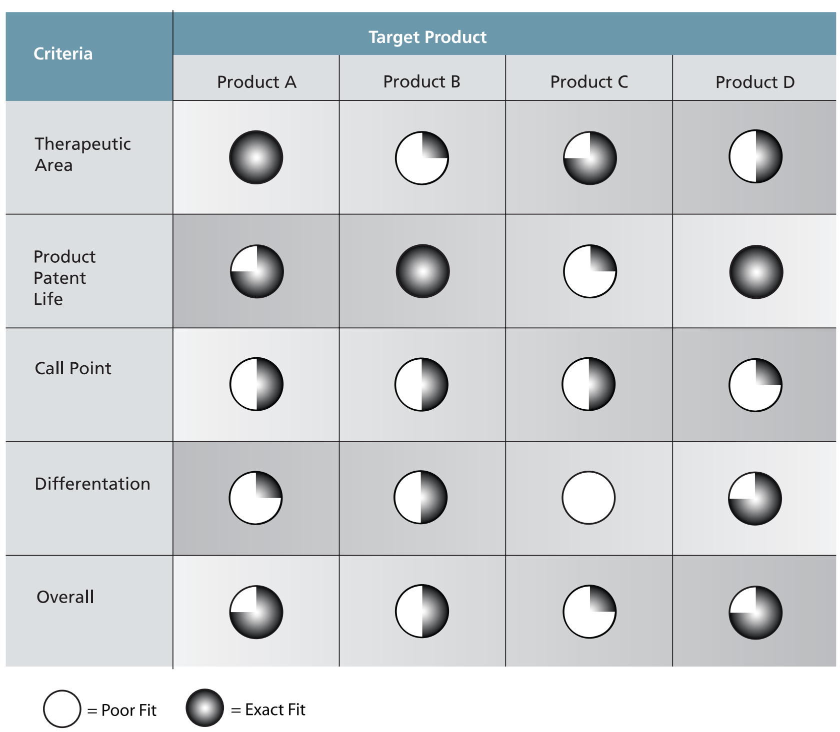
Exhibit 3 illustrates one method for graphically summarizing how well the products being evaluated fit the specified prioritization criteria.

L.E.K developed a comprehensive list of over 2,000 products that was then refined using the inclusion/exclusion criteria. This resulted in a list of 250 product candidates, which was further refined using the prioritization criteria. Each product was evaluated and the data recorded so the research could be updated going forward. Using this process, 30 high-priority products were identified and profiled in-depth. The research that was used to develop the profiles resulted in 10 products being highlighted as the most attractive.

Exhibit 4 summarizes the process of truncating the full universe of potential candidate companies to a highly refined list of targets through the use of a comprehensive screening system.

Efficiently reducing the list from 2,000 products to 10 highly qualified products avoided wasted effort and resources. Armed with the M&A strategy, screening criteria, research findings, rankings, prioritizations and profiles, L.E.K.'s client was prepared to approach the owners of the target products. Importantly, they opened preliminary discussions of a possible deal with the confidence that they were in the best position possible to rationally and methodically explore the most valuable opportunities and were able to complete a deal with one of their top selections.

**Exhibit 3**



**Case Study: An IT Staffing Company Grows Its Business with the Help of Proactive M&A Screening**

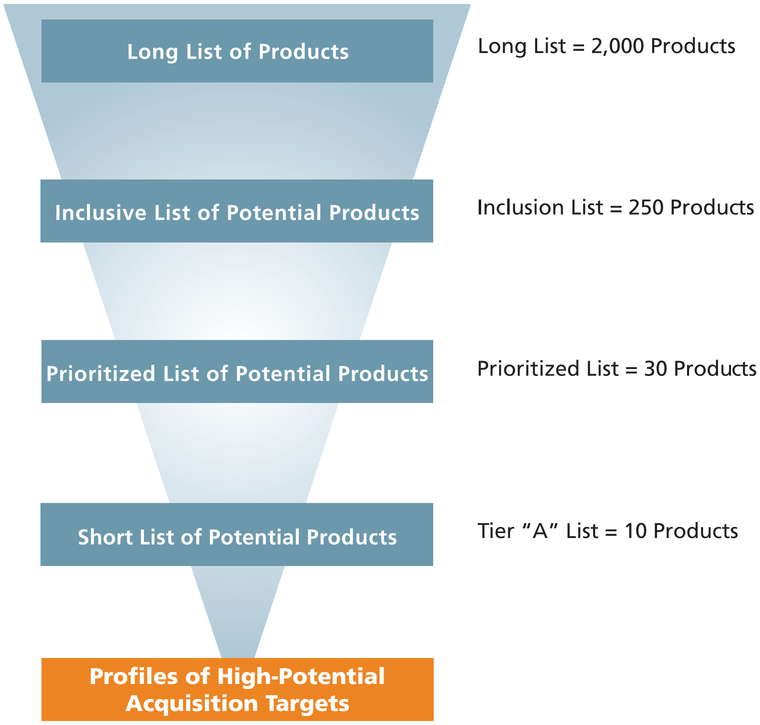
L.E.K. used the proactive screening process to help a company grow its business in the information technology staffing area.

First, a set of criteria was established for potential targets in terms of the size of the company in revenues, geographic location(s), capabilities and skill sets offered. Next, a broad target list was created using a variety of sources, such as member lists from industry trade organizations, to establish a universe of over 900 potential candidates. Duplicates were removed and basic information was captured on each of the companies. Using the inclusion/exclusion criteria, the list was pared down to 120 companies.

The 120 companies were researched in greater depth to prioritize them into A, B or C tiers. Ultimately, additional information was gathered on the A-tier companies – most of which were privately owned – to create more detailed profiles. In approaching these candidates, the client let each one know that their organization had been carefully chosen from a field of nearly 1,000 candidates.

By demonstrating in-depth knowledge of the target companies, the client made a favorable impression on the companies' owners that left them more open to considering and accepting an offer. The L.E.K. client ultimately acquired several of these companies, adding a new and profitable line of business to its existing operations.

**Exhibit 4**




## Conclusion

Mergers and acquisitions will continue to be part of corporate growth and diversification strategies for successful enterprises. However, many valuable deals are overlooked and too many mergers and acquisitions fail to live up to expectations, pointing to opportunity for significant process improvement. As we have demonstrated, taking steps to implement a proactive screening system can contribute significantly to the success of a company's M&A strategy, saving considerable time, effort and resources and translating to positive bottom-line results and increased shareholder value.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to www.lek.com.

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