MASTER THESIS

Achieving extraordinary fit

Adopting simple rules to the target selection process in M&A

Executive summary

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Achieving extraordinary fit: Adopting simple rules to the target selection process in M&A

1. Main topic of the thesis

Research has shown that there are many antecedents for mergers and acquisitions (M&A) that lead to post-deal success. However, the process on how targets are selected, and what criteria are adopted in this process is less researched. Moreover, simple rules as shortcut strategies, as described by Eisenhardt and Sull (2001), create possibilities to better structure this process. It is important to understand why the application of simple rules in M&A processes might be effective because M&As are known for their ineffectiveness and high failure rates. Simple rules are powerful because they provide guidelines and structure within which managers can pursue opportunities. According to Sull and Eisenhardt (2012), this approach provides just enough structure to seize opportunities, linking it to the 'edge of chaos' within complexity theory. Complexity theory describes that systems are unpredictable, due to a great number of interactions and feedback loops that change the system continuously (Burnes, 2005). Acquisitions are a means to keep an organization fresh and vital because it counters organizational inertia and prevents a success trap, whereby organizations focus on their future successes based on current offering, neglecting innovation and sensing of the environment (Vermeulen, 2005). The process of buying and integrating new businesses enables companies to renew themselves. If a firm can put more effort in the target selection and assessment stage of M&A, it might result in higher post-acquisition performance (Hassan, Chidlow & Romero-Martinez, 2016). Being able to better shape the pre-deal process as a firm can bring advantages in the post-deal phase, because a better fit between the buying firm and the target firm can be achieved by adding simple rules.

2. Purpose of the thesis

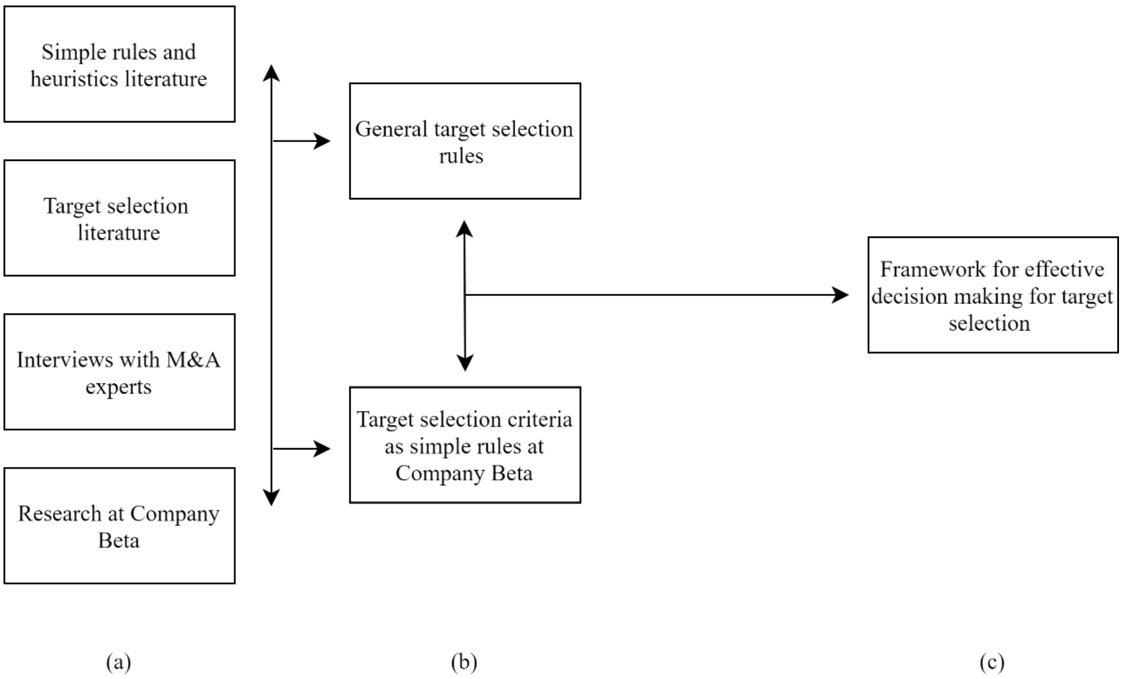
Simple rules have been applied to diverse practices in the business administration literature. The objective of this research is to contribute to the fragmented target selection literature by creating an overview of the important target selection criteria based on the literature and to contribute to the theory of simple rules by Sull and Eisenhardt (2012) and the application of simple rules in the M&A literature. The practical objective is to understand how a company can effectively use target selection criteria in assessing M&A candidates, in order to contribute to the quality of decision making. At Company Beta, we have applied the simple rules in order to create a framework and to assess how the process of implementing these rules works in order to improve decision-making quality. The research question linked to this is as follows: *How can decision making quality be improved in target selection by taking on a simple rules approach to assess M&A candidates?*

3. Research design

The research model of the paper based on the model of Verschuren and Doorewaard (2003), is also shown graphically in Figure 1. In this model, the steps are provided leading to the goal of this research, namely, to create a framework for effective decision making during the target selection phase of M&A. To get here, we start with (a) literature on simple rules and heuristics, and on target selection. This is combined with interviews with M&A experts and research at Company Beta that will eventually lead to (b) general target selection rules and a specified set of target selection criteria defined as simple rules for Company Beta. Together, this will contribute to reach (c) the goal of increasing decision-making quality with simple rules in M&A.

Figure 1

Research set up of this thesis



4. Methods used in this research

As shown in Figure 1, several methods are applied in this research. The first is a literature review, for which 83 articles have been used to identify (managerial) rules that are applied throughout multiple firms during the pre-deal phase. Based on this review, 7 categories are identified. The rules can be applied by multiple acquirers, by using the rules as a basis for which the strategy can be formed.

The rules resulting from the literature review are tested on 11 M&A experts during semi-structured interviews. These experts are working at 11 different organizations in the Netherlands, ranging from M&A advisory to private equity investors. These interviews are transcribed and coded following the procedure of Strauss and Corbin (1990). The third method applied in this research is a focus group at Company Beta. The case of Company Beta forms the basis for setting up the framework for applying simple rules in a firm for the process of M&A target selection. Prior to the focus group, two interviews are carried out to investigate the motives of the firm for acquiring. In the focus group, 3 people participated who all have experience in M&A, either in a buying, selling or advisory firm.

5. Results: Literature review

Simple rules

Simple rules are intended to offer only limited guidance, and can be applied to a specific situation, activity, or process. Not only in business, but throughout the whole community, rules address the most important issues. Developed from experience, by looking at others or from learning through books, rules serve as heuristics to different processes (Sull & Eisenhardt, 2015). In business, the strategy as a simple rules approach can help organizations provide guidelines within which decision makers can look for opportunities (Eisenhardt & Sull, 2001). Broadly, they have considered six types of rules, namely boundary rules, how-to-rules, coordination rules, priority rules, timing rules, and exit rules (see Table 6). Boundary rules help decide between alternatives, how-to-rules provide details on how to execute processes, coordination rules prescribe how to behave in relation to others, and priority rules help to rank different opportunities. Timing rules define the pace and rhythm for processes, and exit rules can be developed for providing details on when to stop pursuing opportunities (Eisenhardt & Sull, 2001).

As Eisenhardt (1989) has shown, decision-makers should move fast and keep pace with the innovations. Fast decision-makers are able to do that by using real-time information, by analyzing multiple alternatives, integrating multiple decisions on different layers in the firm, and by asking for advice (Eisenhardt, 2008; Eisenhardt, 1989). Heuristics show how people make decisions under constraints of information flow and time. This way, optimizing the outcome of a decision by going after all the information will not increase the success of a decision. Gigerenzer (2008) argues that heuristics therefore are a form of satisficing. Satisficing is decision-making whereby a set of alternatives are analyzed with in mind a certain threshold to adhere to. Due to bounded rationality, satisficing often leads to a higher accuracy than other cognitive strategies where more information and calculations are considered (Kruglanski & Gigerenzer, 2000). The authors argue that rules can be defined as an if-then sequence and that principle is accepted by multiple participants in a firm, or in a society. Thus, a rule consists of an instruction. Using rules often makes them to become a routine, where it can seem like a decision is made based on intuition.

Target selection rules

Based on several streams of literature, a set of general rules is set up for target selection, where firms can borrow from. These streams are the M&A pre-deal phase including culture and integration issues (e.g., Bauer & Matzler, 2013; Kim & Finkelstein, 2009; Wang, Hain, Larimo & Dao, 2020), the due diligence literature (e.g., Ahammad & Glaister, 2013; Harding & Rouse, 2007; Shimizu et al. 2004), and venture capitalists' decision criteria literature (e.g., Petty & Gruber, 2011; Zacharakis & Shepherd, 2005). Based on the literature, 7 categories within which the rules fall are distinguished. These are management and human capital, financial capital, product and industry, synergy, culture, integration, and size and location. In Table 1, the rules are outlined along with the articles wherein the evidence is described for the rules.

Table 1

Target selection rules drawn from the literature and from qualitative research.

Rule	Evidence
R1: The management team should have a sufficient industry or leadership track record.	Zacharakis and Shepherd (2005), Muzyka, Birley and Leleux (1996), Siegel et al. (1988).
R2: Retention of the management team and key personnel is essential for post-acquisition performance.	Anslinger and Copeland (1996), Ahammad and Glaister (2011), Ahammad, Tarba, Liu and Glaister (2016).
R3: Employees of the target firm should have enough capabilities (e.g., managerial talent, business competence, technological capabilities, market knowledge, effective HRM policies) that can effectively contribute to synergy realization.	Ahammad and Glaister (2013), Kiessling, Harvey and Heames (2008).
R4: The existence of an exit (rule) is crucial and there should be one present.	Mason and Stark (2004), Very and Schweiger (2001), Lee, Joo, Baik, Han and In (2020).
R5: The product or service of a target should provide for and sustain a competitive market position, or should be protected according to industry standards.	Bapna (2019), Baum and Silverman (2004).
R6: The value-added of the product/service should be high: the improvements in cost-reduction or service quality should represent significant improvements to the acquiring firm's products/services.	Block, Fisch, Vismara and Andres (2019), Petty and Gruber (2011).
R7: Prevent buying targets from very hostile environments (high risk, high dominance), but do look for inefficiencies in a market.	Papadakis (2005), Chatterjee (2009).
R8: If there is a merger wave going on, do not bother buying; it is most probable that the acquisition will not pay out. Consider the timing of buying by watching the market trends can help in acquiring early.	McNamara, Haleblian and Johnson Dykes (2008), Haleblian, McNamara, Kolev and Dykes (2012).
R9: The target firm should have a good number of prominent customers, or sufficient customer spread and alliances or partnerships in place without being too dependent on partners.	MacMillan, Zemann and Subba Narasimha (1987), Baum and Silverman (2004).
R10: The target firm and acquiring firm should preferably overlap in either industry, product, market, strategy, or technology or some combination of them.	Rottig (2017), Renneboog and Vansteenkiste (2019), Kim and Finkelstein (2009).
R11: The target firm should be able to leverage complementary capabilities, or enhance the acquiring firm's competencies.	Wang et al (2020)
R12: There must be enough strategic fit (product strategy or complementing the overall strategy or	Kim and Finkelstein (2009), Ahammad and Glaister (2013).

business model) between the target and buying firm.	
R13: Greater differences in organizational culture led to lower performance. The organizational culture differences should be low.	Ahammad and Glaister (2011), Ahammad et al (2016), Stahl and Voigt (2008).
R14: More integration is a preferred approach to integration. Managers should be wary of selecting the right approach based on the level of cultural differences and the synergy potential.	Haspeslagh and Jemison (1991), Weber et al (2011).
R15: The acquiring firm should choose to take over a smaller firm, but the firm should have a resource base that is able to provide for synergies.	Lee et al. (2020), Papadakis (2005), Tushman and Romanelli (1985).
R16: The acquiring firm should choose to take over a firm that is in close proximity, especially if knowledge transfer and leveraging processes is favoured.	Ramos and Shaver (2012), Schildt and Laamanen (2006), Chen, Kale and Hoskisson (2017).
R17: Gut feeling is important to consider the collaboration potential. There should be a connection between both parties. It must 'feel good'.	Evidence from interviewees: *"Those are soft skills [...]. What happens in a meeting is that two managers meet, and if there is not a connection, then it often goes wrong."* (Interviewee 2, 21-9-2020).

6. Results: Solution

At Company Beta, we applied the strategy as simple rules for target selection in M&A. A framework is set up based on the findings of the interviews and the experiences during the focus group. Firms that want to set up a target selection strategy with simple rules can use this framework. The framework consists of three steps. The first step is to do a self-analysis, by looking into the motives for M&A. The second step is to consider the expectations a firm has. One way to do this is by going through the categories described in paragraph 5 and to question what it exactly is expected of a target in a certain category. Once these expectations are outlined, the expectations must be prioritized. After this is done, the simple rules can be set up, preferably by a team of people who are going to use the rules (Sull & Eisenhardt, 2015).

Once the simple rules are created, they can be filled in a scoring sheet. The goal of the scoring sheet is to help making decisions between multiple alternatives. A traffic light model is incorporated in the scoring sheet, with some rules weighing heavier than others. If these rules are not satisfied, then a target will not be considered for a potential acquisition. The traffic light model is shown in Figure 2.

Figure 2

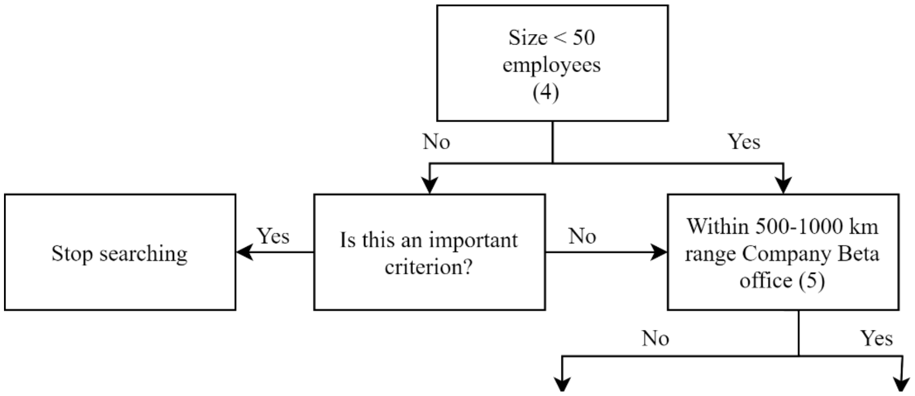
Traffic light model of the scoring sheet

Total	Red = R	First outcome after search criteria only	Go/Stop
	Yellow = Y		
	Green = G	Outcome after including rule 1 and 3	R =
		Rule 1 must be green.	Y =
		Rule 2 must be yellow or green.	G =
		Decision to continue selection process	Go/Stop

In line with this, a decision tree can be created. There is a certain order in how certain rules can be assessed. Some rules are easier to assess than others, for example the size of the firm. The traffic light model is incorporated with the question ‘Is this an important criterion?’. Part of the decision tree is shown in Figure 3.

Figure 3

Decision tree



7. Results, conclusions and recommendations

Based on a literature study, it appears that targets are screened in a certain order by looking at criteria in different categories, namely by looking into the management, financing, products, services, markets, synergy, integration, size, and location. Certain criteria are broadly adopted by strategic buyers, which are defined into a list of 17 rules. Moreover, intuition should be regarded, because some decisions appear to be made because of intuition even though a target can comply with all criteria. Therefore, we suggest that firms consider gut feeling already in the process of setting simple rules. Firms can borrow from these rules and apply them into their own target selection process. The application of simple rules into this process gives the firm the ability to 1) better structure their target selection process by assessing the internal motives for M&A and 2) providing structure to the process while at the same time leaving room for flexibility. We recommend that future research is pointed to researching the success of applying simple rules on M&A performance, for example by doing a longitudinal study. Improving the process of M&A could also improve the outcome of a deal.

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