The Board's Role in Shaping Strategy

By Christopher "Kit" Lisle

Boards of directors tend to be far too laissez faire with company management when it comes to periods of significant change and uncertainty. Some boards do take an active role, but most tend to let management make ill-informed strategic decisions during these periods of flux.

When the following strategic situations occur, active board involvement is required:

1. There is a declining earnings growth.
2. Competing alternatives are viewed as options for growth.
3. An external dynamic threatens to create lasting change.
4. There is a merger or acquisition.
5. There is a sale of the company or issuing stock.

In each of these situations, the company is facing a critical decision and needs the input of the board. Firstly, the board should consider using an objective, third party to gather sufficient data (and turn this intelligence into analysis and options for management); secondly, the board should insist that management translate the analyses and options into a clear decision (with the assistance of the board), and that this decision include clear action steps for management; and thirdly, the board should require a dashboard of developments, or some means of maintaining a simple awareness of progress—and hindrances—over time.

Declining Earnings Growth Rates and Strategy

Companies that are facing declining earnings growth often become anxiety-ridden, but fail to make critical decisions. They often have three realizations, which do not serve to aid the company unless it takes action:

1. They do not know why earnings growth rates are declining.
2. They believe there must be an opportunity in the market that they are missing.
3. They cannot ignore the current decline because margins are already low.

Of these three, the third is the most important. Not only do firms recognize that they cannot ignore the trend, they acknowledge that they have no idea how it came about or how to get rid of this "lack of growth" problem.

The board can help by strongly suggesting that there is a need for insights about the market as a whole. There is a need to understand which segments are growing and which are not. It is possible that the company merely finds itself competing in the least attractive segment of an otherwise attractive market. Once the pockets of opportunity are discovered, in terms of market size and growth rate, there must be an understanding of the critical success factors of competing in these segments. What are the customer needs and what are the competitors' intentions and capabilities?

Customers and competitors can tell the company what it has been doing wrong—if anything. In other words, by contacting current customers and current competitors, the company may learn that customers' needs and interests have evolved somewhat. Competitors may be more familiar with these needs than your company. We once worked with a large supplier of food ingredients. It believed its size was a guarantee of success and a barrier to entry. It was wrong. Two small start-ups began their operations by providing the same ingredients to the same large-brand food customers as our client. The difference? The small start-ups recognized that each customer segment (consumers of trail mix, breakfast cereal, baked goods, and so on) wanted slightly different colors, textures, sweetness ratings, and plumpness levels. By tailoring ingredients to meet the needs of one customer

Director Summary: When a company is in a state of transition, due to anything from a merger to an uncertain economic climate, the board has a responsibility to be well-informed and oversee the company's strategic options.

segment at a time, these two small competitors were explaining to our large client what they were doing wrong.

The board's role was to insist that the company needed humility and an openness toward gathering fresh insights. The board demanded an action plan with a clear statement of what would be done, how it would be carried out, what resources would be required, what the expected benefits were, and what the timeline would be. The board received a simple one-page dashboard and were periodically provided an update on progress.

Competing Alternatives

Some fortunate companies find themselves facing multiple strategic growth options. Each seems worthy of pursuit. Management recognizes that it cannot carry out all of the initiatives it faces. We once worked with a small, but highly innovative manufacturer of baseball and softball bats. The company's managers had a few ideas of strategic initiatives to pursue. The CEO had a few new ideas of his own. They presented these ideas to the board, which added a few more. Altogether, the company could see twelve strategic growth opportunities. It could not decide which to pursue.

Clearly, the company needed to gather facts to facilitate a comparison so that it could tell which opportunities were truly most robust. Yet, the process was not simply a matter of gathering data. There needed to be a systematic methodology to gather specific insights on each presumed opportunity so that the board could oversee an informed strategic decision. Each of the presumed opportunities should have had a clear breakdown of the following:

- Size of the presumed opportunity
- Growth rate of the market
- Opportunities and threats of the situation
- Critical requirements
- Competitive analysis
- Customer needs assessment
- Costs
- Timeline
- Human capital requirements
- "Fit" with the current operation

The board's role in this situation was to ensure that management did not make a major market entry decision based simply on gut instinct, historical experience, guesswork, or a one-dimensional perspective. The board had to require that a major strategic decision, involving a new opportunity to pursue, would be made only after gathering sufficient data from multiple perspectives. It understood that this data would need to be organized and analyzed to create options. It also expected a clear recommendation for the board.

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External Dynamics

There are only two kinds of change: change that we bring about ourselves, and change that is forced upon us. It is the latter kind of change that concerns us here. This external change can involve four distinct realms:

- Emerging trends and market dynamics
- New or shifting competitors
- Changing customer needs
- Evolving supplier intentions

Market trends can change the requirements to becomming a legitimate, capable player in the given market. Consider the possibility of a raw material substitution, a regulatory or legal change, a change in the nature of distribution, or a simple shift in the norms, preferences, and practices in the marketing and sales of products or services in the market. We recently worked in the industry that produces screen printing inks. In that industry, a fundamental shift was ongoing toward "green" inks. Similarly, several years ago in the wooden furniture and fixtures market, there was a pending requirement to provide "green" products. The market trends changed the expected behaviors among competitors by changing raw material requirements.

Rather than reacting to changes, however, market participants should determine, proactively, where the growth and profitability will be coming from in two-to-five years. The most important research objective is to learn how the changes in the market will impact the customers' needs and the competitors' actions. The research should provide analyses and options as far as what changes your company should consider for the future.

Competitor changes involve both capabilities and intentions. Boosting capabilities without changing intentions simply means the competitor will be doing more of the same, but with an enhanced zeal or fervor. Altering its intentions without adjusting capabilities may mean the company thinks it already has the requisite capabilities or that its capabilities are more substantial than the com-

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petitors. Boosting capabilities and changing intentions, as in the case of one competitor in the school supplies market, indicates conviction and may demand action or reaction on your part. An employee with whom we spoke during our research explained his company's five-point strategy for entering an ancillary market and its rationale for doing so. Our client decided to emulate this strategy and beat the competitor to the punch. But the decision was made only after close involvement and discussions with the board.

For competitor changes, the research should focus on trying to see what the competitors see. Why are they changing their capabilities or intentions? Should we follow suit and try to compete head-to-head with them? Or, do we know something they do not know? Should we just let them drive themselves off a cliff, while we move in a more appropriate direction? We want to understand where the actual customer and market opportunities lie, relative to the competitors' positioning strategies.

As customer needs change, we should strive to understand, in real time, how these changes impact buying behavior. Customers' unmet needs obviously evolve, but we should understand how these changes in wants and needs actually impact the criteria that are used to select a vendor. What are the factors that customers use to select a new supplier, and how do they weigh or rank these factors?

Customers' needs may change independently, or as a group. I have witnessed an entire segment of customers decide, as the result of a market trend or dynamic, that they need to pursue a particular new technology. In other cases, we have witnessed one customer make a distinct switch in its purchase decision process that its competitors (other customers of our client's) did not emulate. When one large customer makes a profound switch in its purchase decision process, it can be a difficult decision to accommodate this customer (which may disrupt operations for the rest of the business) or to walk away from it. The board needs to be involved in these kinds of decisions.

Sometimes suppliers make bold decisions that can impact your industry. For example, they may decide to forward integrate and compete with their customers. Facing a supplier that suddenly wants to become a competitor is no small matter. This often happens when the supplier believes there is a market inefficiency in the distribution chain—and that one step in the distribution chain can be skipped. If your company happens to be the step that can be skipped, your company is facing a significant strategic transition decision. Careful research, analysis, and the development of options and recommendations are obviously necessary. The board needs to insist that this activity take place.

Supplier changes need to be understood through the context of their future intentions for the market. Do they intend to become competitors with their customers? Do they intend to raise prices? Do they intend to place less emphasis on the market? When a major supplier begins to change its strategic direction, there is a clear need for a fact-finding mission to determine the impact this change may have on your business.

Regardless of what type of external change is occurring (market, competitor, customer, or supplier), there are facts that the management team should gather when your organization begins to notice an external change. The board's role is to ensure that management is actually gathering these facts. The board can play devil's advocate with management, and ensure that management is war-gaming alternative scenarios. When significant external changes are occurring, the board needs to become comfortable that management understands the reasons for the changes, the impact of the changes, and where the opportunities will reside after the changes occur.

Merging with or Acquiring a Company

When considering an acquisition, it is important for the board to provide clear direction on the role the acquisition will play in overall strategy. How will the acquisition serve to fulfill the goals of the company? What are the criteria that would make a candidate attractive or unattractive? Do the board members have any suggestions of organizations that might be good starting points?

The company needs to develop a list of prospective acquisition candidates (regardless of whether they are actively for sale), and begin screening them against the acquisition criteria, rather than reacting to a random "for sale" deal of the moment. The company will need to gather additional data, in order to round out or confirm its knowledge of the acquisition candidates. The management team may wish to use an outside party to approach, anonymously, the owners or board members of the most attractive acquisition candidates to determine if they are willing to consider an acquisition. After the seller agrees to a deal and has signed a letter of intent to sell, management will need to begin diligence on the range of financial, legal, business, technical, insurance, and other aspects of the deal.

The board's role in this situation is to clarify how well the acquisition target fits the goals and strategies of the company. The board should ensure that management has a very clear understanding of the acquisition target's fit, before and after diligence. After pursuing the ideal candidate, management should conduct a due diligence review to gather insights. The board needs to be certain that the company in question is the appropriate company to accomplish its goals and objectives.

Sale of the Company or Issuing of Stock

As in the case of the acquisition, a decision to sell should be accompanied by a clear understanding of how this decision complements the overall goal of the organization. The company should have a clear strategy to achieve a clear, well-understood goal. When a company has decided it is time to sell, it should begin the process of tying up loose ends that a buyer may discover during diligence. Legally, and from an accounting, technical, insurance, and business operations standpoint, it should review the business as if it were a prospective buyer. What would cause alarm or reason for concern? In other words, it should conduct sell-side diligence on itself, before the buyer has the chance to do the same thing. The board should ensure that this diligence takes place.

From a business operations standpoint, it should consider the rationale and efficiency of the flow of material through the facility from source of supply to finished product. The board should consider its human capital competencies and the culture, communication, compensation, and commitment of management. It should seek to understand the nature of relationships with customers so that it is not surprised by the results of the buyer's calls to customers. It should consider its positioning in the market, relative to pockets of growth. It should boost its awareness of competitor capabilities and intentions.

The board's role in making and executing a decision to sell part or all of the company is, first and foremost, to consider the value to shareholders. Is now the best time to sell? Is the company prepared for a sale? Has the company considered potential buyers, their interests, and needs? Has the company—over the past couple of years—made itself as attractive as possible to a high-target buyer?

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Conclusion

During these periods of change, transition, and uncertainty, the board must play an active role in looking out for the best interests of the shareholders. Acquisitions, divestitures, external market change, competing opportunities for growth, and declining margins are all examples of strategic transition situations that demand board member attention and involvement.

Not surprisingly, all of these situations require data in order to facilitate fact-based decision making during these periods of change and uncertainty. Research is likely to involve *primary* research—direct interactions with the movers and shakers in the marketplace of interest. And the research should be at least as qualitative as quantitative. Qualitative research investigates the why and how of decision making, not just what, where, and when. The board must ensure that management takes the facts, absorbs them with minimal internal bias and defensiveness, develops an action plan resulting from facts, and creates a dashboard to update the board on management progress on an ongoing basis. During periods of strategic change, that is the board's role. ■

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