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Creating value through M&A in the Medical Technology Industry

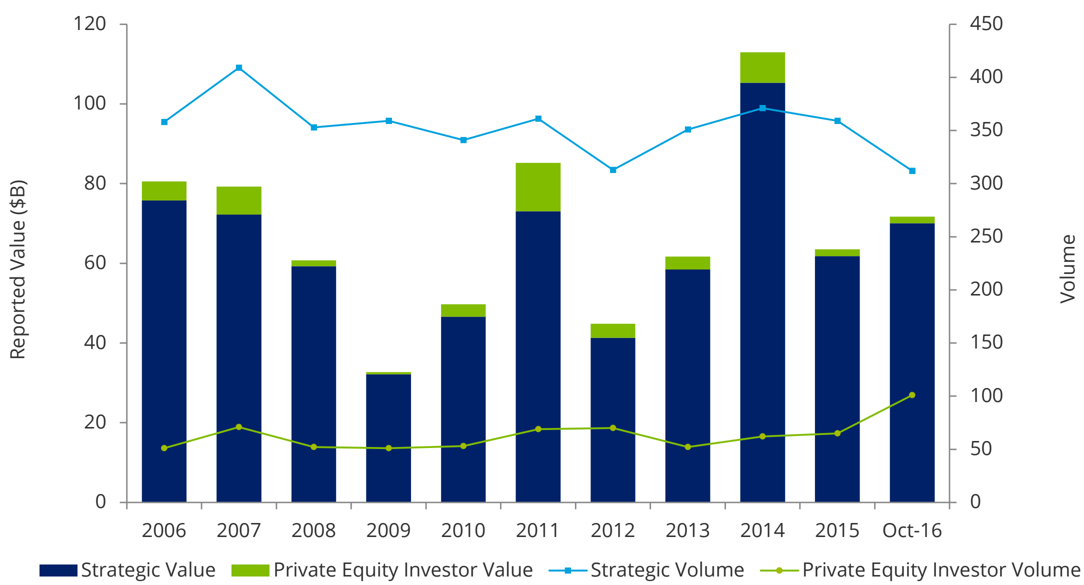
Medical technology companies continue to leverage M&A to drive growth and profitability

The Medical Technology (MedTech) industry continues to face significant changes driven by health care and regulatory reform, industry consolidation and convergence, and technological advances (e.g., wearable technology). These changes create both opportunities and challenges to existing business models, growth projections, and financial performance. Furthermore, negative pricing trends, and stagnant health care spending have created headwinds that may stunt MedTech companies' ability to meet their strategic and financial goals.[1] In recent years, MedTech companies have looked to mergers and acquisitions as a key strategic lever to address these industry changes and drive stronger financial performance.

Broader portfolio offerings, enhanced therapeutic solutions, international expansion and increased scale and leverage are some of the primary motivations underlying recent M&A activity.

While recent years have seen M&A transactions of significant, but varying, size (in dollars), the volume of transactions has remained relatively consistent (Figure 1). Additionally, many of the drivers for M&A activity in the MedTech industry remain constant. As companies consider future M&A activity, a strong understanding of premiums and value creation will be critical.

Figure 1. Global MedTech M&A Activity



Source: Thomson Reuters, PMCF. Includes reported transaction for target companies with the following industry designation: Surgical & Medical Instrument Manufacturing (NAICS 339112), Electromedical and Electrotherapeutic Apparatus Manufacturing (334510), Irradiation Apparatus Manufacturing (334517), Surgical Appliance and Supplies Manufacturing (339113)

[1] 2016 Global Life Sciences Outlook: Moving Forward with Cautious Optimism, Deloitte

MedTech deal premiums and value creation

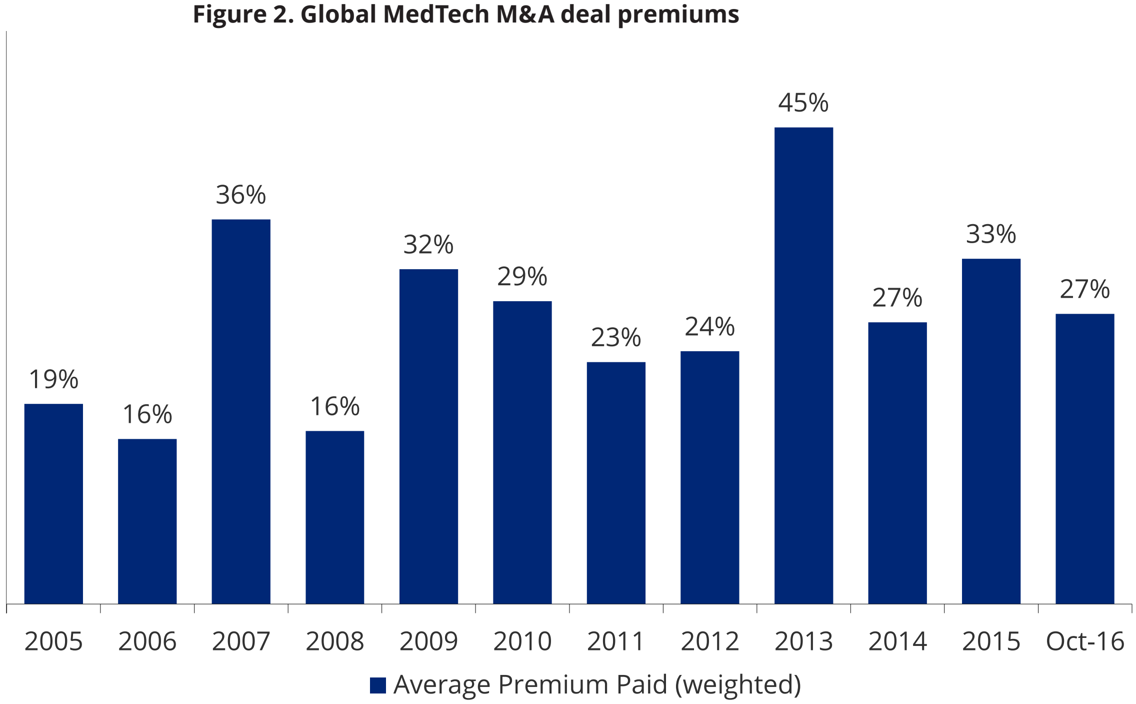
The continued strength of M&A within MedTech and, to some extent, the competition for a limited set of strategic assets, has driven deal premiums to a level that may represent an opportunity or a barrier to play, depending on a company's financial position and risk tolerance (Figure 2). In fact, in recent years, the weighted average premium paid in global MedTech deals has hovered around 30 percent. Given the industry's average growth rates of three to five percent (3-5 percent), high premiums drive a need for significant value generation in the transaction – mostly in the form of revenue and cost synergies.

The premiums also create pressure for companies to understand the deal's potential synergies before entering into a transaction, and to have a sound integration plan to capture identified synergies to justify the premium to the Board of Directors and shareholders.

Analysis of data from a sample of recent MedTech deals suggests "announced" synergies range from seven percent to 22 percent of the target company's last 12 months (LTM) revenue, with a median synergy target of 11 percent[2] (Figure 3). It should be noted that these are the publicly communicated goals; more often than not, companies have higher internal targets to mitigate risk in executing these synergy plans.

In many of these deals, the announced synergies are mostly cost synergies. While topline growth is often critical in transactions, companies are less likely to make public commitments to revenue synergies, as these often have a longer timeline to achieve and can be more difficult to track. For many acquirers, revenue synergies may be perceived as a potential for upside and risk mitigation to justify the deal premium.

Figure 2. Global MedTech M&A deal premiums



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[2]Company filings, press releases, publicly available data

Creating value and synergies in MedTech M&A

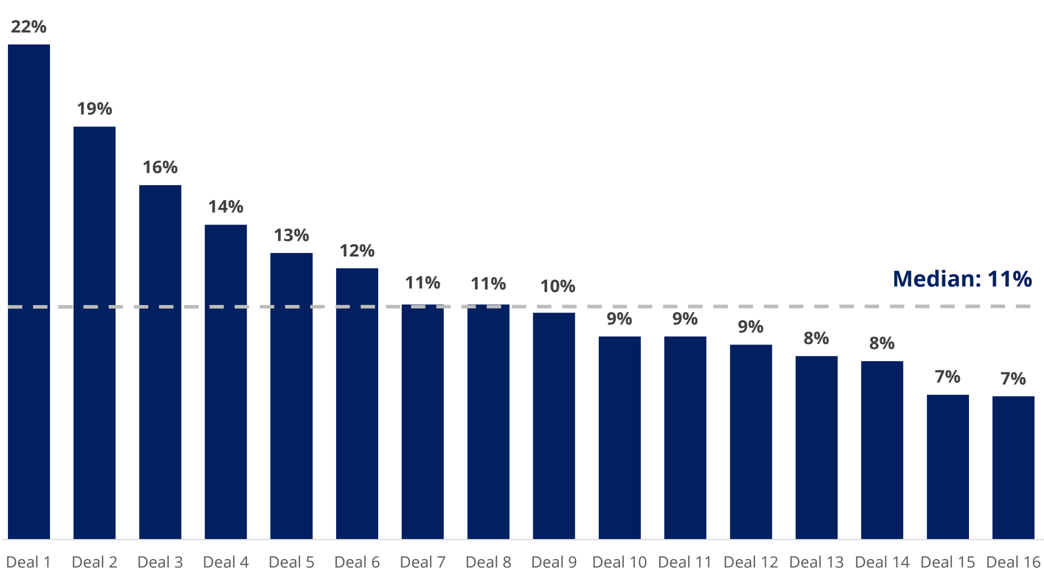
While much of a deal premium may be justified externally by cost synergies, there are a number of examples of MedTech transactions that are driven both strategically and financially by revenue and growth opportunities. These may include transactions with enhanced portfolios in a particular segment (e.g., cardiology), advantaged "call point" opportunities (e.g. Intensive Care Unit [ICU]), and international market or channel expansion.

Projecting revenue synergies tends to be more difficult than projecting cost synergies, and should be analyzed in for particular deal. However, there are a number of common opportunities that MedTech companies leverage to drive upside revenue. Each of these levers can create significant value in the transaction, they should be explored early in the deal process and executed in a robust manner throughout the integration.

Common revenue synergy levers include:[3]

- **Cross-selling initiatives.** Cross-selling can be capitalized in different phases of a transaction, and the level of execution sophistication can increase as the integration progresses. The ability to leverage relationships, call points, and enhanced product/solution offerings is a key driver in most revenue transactions.
- **Sales channel optimization**. This can act as both a cost synergy and a growth driver. Focus on the channel strategy (e.g., direct vs. distributor) as well as optimized plays within channels (e.g., consolidation) can drive significant upside.
- **Pricing, contracting, and tendering.** A combined portfolio can bring significant opportunities to product and portfolio pricing, and increase leverage in the tendering process, creating a strategic advantage relative to competitors and in pricing negotiations.
- **Portfolio optimization.** This can also be both a cost synergy in terms of SKU rationalization, as well as a strategic play to improve focus on the higher-margin products and solutions.
- **Geographic expansion.** Expanding on the previous levers, disparities in market reach across two MedTech companies can create a real opportunity as they leverage combined infrastructure to bring both companies' products into new markets.

Figure 3. MedTech announced synergies as a % of target LTM sales



Source: Company filings, press releases, FactSet, ThomsonOne

[3]Deloitte Analysis

While revenue synergies are of critical importance to many deals, the cost synergies have often been the backbone of value creation in the MedTech industry. Of course, similar to revenue synergies, each transaction has its own unique drivers and synergies. That said, in analyzing a number of MedTech deals, data suggest that the sources of cost synergies for MedTech transactions often fall within a consistent set of key drivers and can be summarized in four main areas–commercial, operations, enabling functions (e.g., HR, IT, Finance), and Research & Development (R&D) (Figure 4).

Cost synergies can be achieved across each of the main areas and can contribute significantly to the overall deal value. The differences in the source of cost synergies across deals are often driven by parity in business models and products–the more similar the business, product lines, or channels, the higher value that a company can expect from commercial, operations, and R&D cost synergies. Of course, the opposite is also true. For example, companies that have acquired for scale tend to be focused on achieving the synergies and value through the enabling functions, such as public company expenses and back-office leverage.

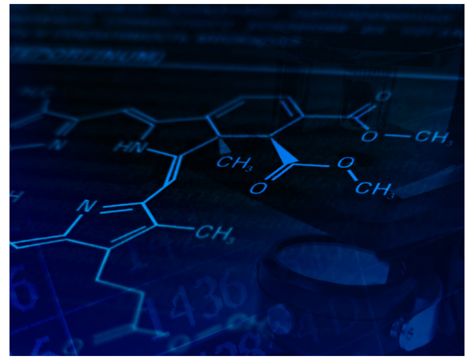
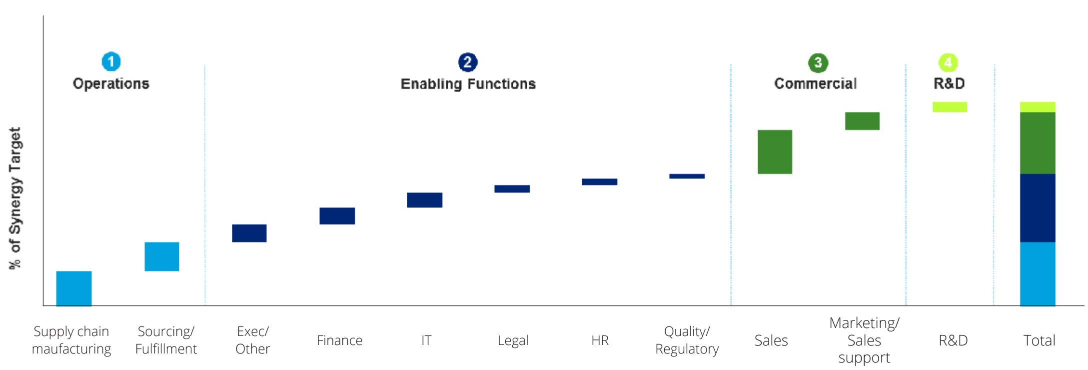


Figure 4: Cost synergies by function



NOTE: Representative data, based on multiple MedTech transactions

Source: Deloitte Analysis

Key cost synergy drivers, levers, and constraints include:

- **Operations**. Often dependent on the parity in business and geographical focus of the two companies; synergies are driven by manufacturing and supply chain consolidation, footprint optimization, and sourcing opportunities from improved leverage. While MedTech companies can experience significant savings in Operations, compared to other industries, the regulatory and quality implications can delay or reduce desire to drive these synergies.
- **Enabling functions**. Typically driven by a combination of public company expenditures that can be optimized, elimination of back-office redundancies, and optimized service delivery models.
- **Commercial**. Emphasis on channel consolidation and optimization as well as direct sales force effectiveness and productivity improvements can drive significant savings, particularly where products and solutions are complementary.
- **R&D**. Common existing products allow for portfolio rationalization, reducing R&D program and service-related spend. New product development parity can drive savings in project and R&D facility footprint reductions and /or clinical trials. In some deals, MedTech companies may achieve less synergies in R&D as they focus to maintain momentum in current programs and to avoid stifling innovation.

While our analysis and experience suggest a number of areas of focus and considerations for revenue and cost synergies, there is no "one size fits all" approach or model. With M&A deal volumes continuing into 2016, and with continued pressure on synergy capture to justify deal premiums, MedTech companies should adhere to a consistent, robust set of leading practices both prior to and post-deal to leverage value.

Making synergy and value a key part of the deal process

Prior to announcing a deal

Merging or acquiring companies tend to rely on high-level, top-down assumptions to identify synergies that are built into valuations. The diligence teams often gloss over cost reductions that are perceived as easy to achieve. This oversight can have significant ramifications on realized value and management credibility if those synergies do not occur or are delayed.

This issue can be addressed through the diligence process with a strong emphasis on synergies and value creation.[4] This process uses a bottom-up approach that verifies where specific cost reductions can be achieved to justify valuations. It drives early consideration of synergy capture planning during post-merger integration. Most of these "diligence and plan" efforts follow four steps:

- **Develop cost baselines**. Create consistent cost and functional baselines that map the cost pools from the combined P&L to specific functional areas, and tie the headcount numbers and specific roles to allow for overlap identification.
- **Execute a robust synergy analysis**. Quantify potential synergy opportunities by functional area through detailed interviews with acquirer executives and functional leaders; develop a prioritized view of the opportunities.
- **Understand the differences against benchmarks**. Develop a financial model and explain variances from initial top-down synergy assumptions; rationalize and analyze before finalizing the deal model.
- **Align the operating model and understand the costs**. Understand the integration model and the costs to execute the synergy plan; verify that the plan aligns with expected synergies.

Too often, companies find themselves in a position in which the synergies are unachievable, not aligned with intended post-integration business model, or too costly to actually implement. To potentially avoid these pitfalls, a robust synergy diligence process should encourage management involvement, input, and personal commitment from the outset. A robust process stress-tests the valuation according to size, timing, and costs required to achieve synergies. Furthermore, the diligence process is designed to achieve both significant risk mitigation in deal execution and synergy capture, as well as provide a head start to value creation post-close.

After deal announcement

Many deals fail to create their intended value, and there are often numerous reasons for this. One way to mitigate this risk is by implementing a robust synergy management process during the integration phase. At times, companies fall into the trap of loading the synergies into the budgets and then expecting that the synergy capture activities will happen on their own. In this case, the lack of visibility to actions taken and understanding of true synergy achievements will likely result in savings leakage and increased costs over the long run. Successful synergy capture examples share some common practices:

- **Think big**. An integration should be treated as a major opportunity to explore new operating models and catalyze transformation. Internal targets should be set in a way to stretch the teams' thinking (and create risk mitigation for the program). Aligning strategic deal rationale with a fact-based approach creates the potential for teams to exceed public synergy targets and leverage shareholder value.
- **Leverage a Clean Room**. Leverage a Clean Room. A Clean Room can help overcome impediments (regulatory, strategic) to early integration/synergy planning and can be efficiently leveraged to front-load synergy capture and develop a strategy to to preserve existing business at close.
- **Implement a robust tracking approach**. This can seem like incremental work on top of existing financial reporting, and at times it is, but robust tracking is critical to help ensure that actions are taken according to the plan and to gain the confidence of the Board of Directors and investors in your ability to execute.
- **Work as a team**. Operational synergies should come from both the target and acquirer. Teams should focus on building optimal functional units with accountable leaders to best support the combined organization.
- **Use a balanced approach**. Defining bottom-up initiatives and refining team baselines are iterative processes. Companies should front-load the synergy planning and execution as much as possible, yet balance synergy execution over time, as appropriate, to maintain business continuity.
- **Perform with a purpose**. Realized synergies can give the combined company additional firepower to reinvest in growth and achieve broader transformation. Value capture activities should be embedded into existing business activities and linked to key strategic and financial goals.

The ability to show demonstrable results can strengthen a company's ability to pursue future transactions in this industry, particularly given the premiums, by building confidence across the management team, Board of Directors, and shareholders. Following these leading practices, companies should make synergy capture a core competency that lays the foundation for successful M&A value-generation throughout throughout the organization's future.

[4] *Due Diligence for Synergy Capture: Building Deals on Bedrock,* Deloitte

Case study: Creating value in Med Tech M&A through synergy capture

A global life sciences organization completed a multi-billion-dollar acquisition of a large MedTech company to become the leading player in its market.[5] The deal complemented the acquirer's product portfolio, helped grow its top and bottom lines, and expanded its global presence.

Like all major transactions, the integration came with its share of issues and challenges. Not only was the organization tasked with rationalizing product portfolios, prioritizing various synergy initiatives, and maintaining business momentum while adding growth, it had to achieve all of these objectives while addressing interdependencies between functions and across 40+ countries. The organization leveraged a cross-functional model and global integration team to approach these challenges.

The Integration Management Office provided guidance across and throughout the transaction to implement the following practices:

- Strong financial baselines and quantification of synergies in line with headcount and cost baselines
- Identification of specific value-capture initiatives with associated spend and savings (by quarter)
- Robust tracking and reporting processes to monitor synergies and costs that were embedded into financial plans and results (monthly operating reviews)
- Regular meetings and workshops to establish priority alignment and issue resolution

As a result of this approach, there was clear ownership of synergy targets and accountability for the necessary costs to achieve, as well as a defined, prioritized set of cost and revenue synergy drivers to guide value-capture execution. Specific cost-synergy-driving initiatives were centered on eliminating redundancies, enhancing productivity, and realizing efficiencies. Revenue synergy drivers included improving pricing in light of an expanded portfolio, leveraging cross-sell opportunities, and gaining additional revenue through geographic expansion. To achieve its aggressive synergy targets and fully realize the potential of the identified value drivers, the organization implemented robust tracking and reporting tools, as well as recurring synergy performance assessments, to inform decision-making, identify and mitigate risks, and prioritize integration actions and expenditures.

The value capture team helped lay the groundwork for global commercial growth and unlocked the potential for the organization to exceed its synergy targets.

[5]Deloitte analysis

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