

Medical Technology M&A Market on the upswing?



Capitalizing on core, adjacent, and new growth drivers

Marketplace developments are making mergers and acquisitions (M&A) more attractive than they have been over the last several years; indeed, 2014 has seen a significant uptick in M&A activity. Five key factors are driving this changing environment. M&A can help medical technology companies overcome growth challenges and capitalize on opportunities within a relatively short timeframe. This paper offers suggestions for companies exploring M&A to consider in building a successful strategy.

Medical technology macro trends are making M&A more attractive than in recent years

Five key marketplace developments are changing the M&A climate.

1. While health care reform and its new programs and regulations will continue to evolve, many reform-related changes have begun to be implemented. Greater understanding of the implications of these policy changes, including the medical device tax and Affordable Care Act, has led to less uncertainty in the marketplace. Many medical technology companies are looking to capture key opportunities under existing regulations—corporate inversion opportunities are the most recent example driving deal activity.

2. Broadly speaking, economic conditions in the US and internationally have improved since the lows of 2009, which, in turn, are generating more positive cash flows and economies. This trend is generally increasing shareholder and investor confidence as well, and driving more capital into the medical technology market. Such increased optimism is changing investors' risk tolerance for M&A activities, resulting in less emphasis on stock buy-backs and more on capital and growth investments.

3. With an anticipated three to five percent market growth rate, acquisitions may provide significant opportunity to drive higher company growth more quickly and economically (Figure 1). While technology innovations have the potential to drive significant cost reduction and improve care, the regulatory environment will likely continue to challenge and slow new product development. Moreover, past cost pressures have led to reduced R&D spending, so fewer products are in the pipeline, much less approved. "Make versus buy" decisions will likely continue to dominate corporate strategy and steer companies toward inorganic M&A activity.

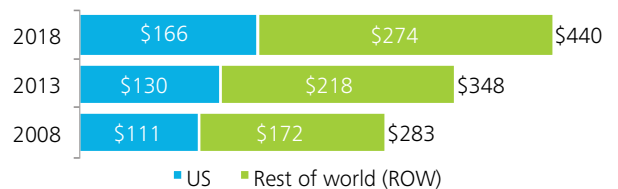
4. Greater scale and scope can be helpful in navigating a more consolidated provider market. As health care consolidation and convergence continue, medical technology companies will likely find that pricing and margin pressures will be difficult to manage without significant scale; therefore, increased scale domestically, as well as internationally, may be required for near- and long-term sustainability.
5. Finally, many medical technology companies are more organizationally prepared for M&A activity—several years of cost and margin improvement and restructuring, coupled with smaller portfolio optimization activities, have built a solid platform for growth. Further, many US-based companies have enhanced their international M&A capabilities through an increased focus on emerging markets and cross-border deals, particularly in light of corporate inversion opportunities.

What's at stake: Medical technology industry is expected to grow to \$440 Billion by 2018

Over the past several years, the US medical technology market has shown consistent mid-single-digit growth, with pockets of high growth in select sub-industry segments. While growth rates vary within and across each subsector, the US market as a whole is expected to grow three to five percent between 2013 and 2018, consistent with a global growth rate of 4.8 percent (Figure 1).

Figure 1: Forecasted medical technology market growth

Global Medical Technology* Market size by region^{1,2} (\$B)



Global Medical Technology market growth by region^{1,2}

	Growth rate ('08-'13)	Growth rate ('13-'18)
Global	4.2%	4.8%
US	3.2%	5.0%
Rest of World (ROW)	4.9%	4.7%

*Definition of Medical Technology and segments involved in calculating market sizes may be different for US and global market (as two different source documents are used)

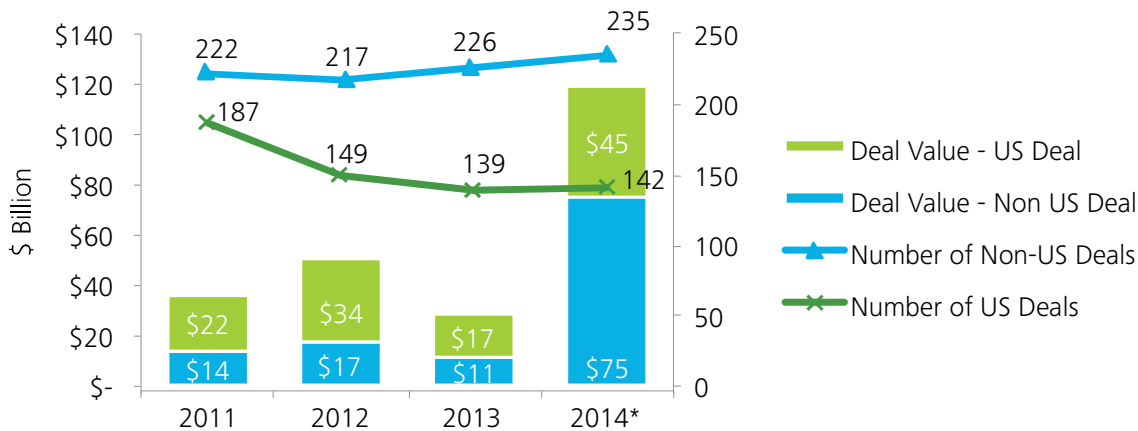
Sources: 1. "Medical Equipment and supplies: United States," Freedonia, March 2014; 2. "A consensus view of The Medical Device and diagnostic industry," EvaluateMedTech, October 2012; report from Scottish Enterprise on Medical Technologies Overview, 2011

Our take: After several years of slow activity, M&A activity has increased markedly

2014 has seen a significant amount of M&A activity. 2014 YTD shows a rebound in terms of number and value of non-US deals, including several mega deals tied to a corporate inversion. Looking ahead, market and economic conditions are expected to continue to create a favorable climate for M&A.¹ The increased activity is evident in recent announcements in both the life sciences and medical technology segments, including several mega-deals. Examples include the \$13.35 billion deal announced by Zimmer to acquire Biomet² in April 2014; as well as the proposed acquisition of Covidien by Medtronic for \$42.9 billion in cash and stock, which is expected to close in the fourth quarter of 2014 or early 2015.³

Figure 2: Medical technology deal volume and value, 2011 to October 2014

Number of Medical Technology deals and deal value (\$B)



*2014 date has been annualized (based on available data until October 30, 2014).

Source: Thomson Mergers and Acquisitions database, accessed October 30, 2014.

Notes: Includes closed transactions where either the target or the acquirer had a primary SIC aligned to the medical technology industry sector. "US Deals" were transactions where both the acquirer and the target were US-based firms. For 2014, deals announced (and not closed) with deal value greater than \$500 million included as well.

- **US M&A activity leads the way.** The US-based acquirers were involved in more than 53% of deals, both domestic and international, during the period of 2011-2013.
- **US companies offset domestic declining M&A rates with international deals.** In 2013, US-based companies increased international acquisitions by 21 percent, while the number of deals involving non-US firms acquiring US businesses remained almost constant.

¹ Thomson Mergers and Acquisitions database. Accessed October 30, 2014.

² "Zimmer/Biomet: The Deal that Shook Warsaw, Ind.," Wall Street Journal, April 24, 2014. <http://online.wsj.com/news/articles/SB10001424052702303834304579521273613231670>. Accessed May 8, 2014.

³ "Medtronic to buy Covidien for \$42.9 billion, rebase in Ireland," Reuters, June 16, 2014. <http://www.reuters.com/article/2014/06/16/us-covidien-medtronic-inc-idUSKBN0ER03420140616>. Accessed June 30, 2014.

Over the last several years, M&A activity slowed in response to trends that were affecting the broader health care industry—including implementation of health reform, consolidation and convergence, economic conditions, and evolving technology and health care models. Adding to this, several additional factors have impacted M&A; for example, access to capital was more challenging, as venture capital and private equity firms turned to higher-growth segments which also offered less uncertainty. Also, lack of shareholder and investor confidence in market growth and successful M&A strategies caused investors to push for cost containment and share buy-back models rather than acquisitive growth strategies and constrained non-accretive deal models. In addition, the complexity of international deals, some US-based companies' lack of experience in emerging markets, and investor skepticism caused M&A limitations even as emerging markets experienced significant growth.

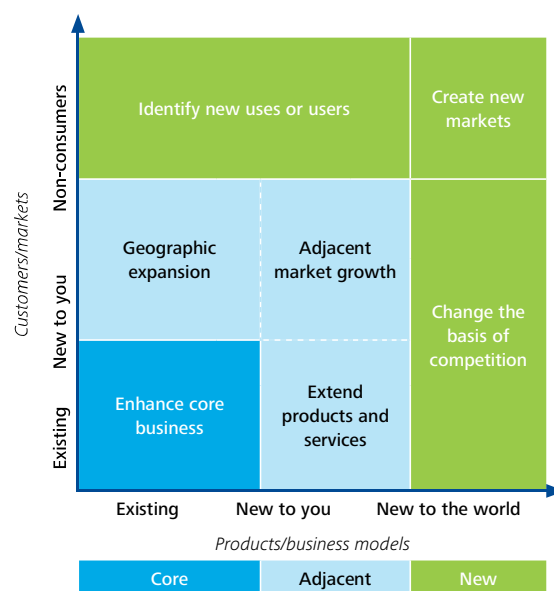
As discussed earlier, both overall economic conditions and market trends are creating a more favorable environment for M&A activity. With the premise of increased M&A activity, medical technology companies should consider: a) how to effectively develop an M&A-based growth strategy to get in front of the curve (and competitors), and b) how to effectively prepare and execute that strategy.

The path forward: Developing an M&A-based growth strategy

M&A continues to help address growth-related challenges within a relatively short timeframe so it's critical that companies develop an effective, holistic M&A strategy. This strategy should consider the company's core competencies and how the aforementioned macro trends may impact the medical technology industry. Companies considering the impacts of provider consolidation, for example, may look to expand their product portfolio to increase its relevance to a changing base of purchasing decision-makers. Or medical technology companies may look to add solutions and services that provide more integrated offerings and meaningful outcomes.

Figure 3: An example framework for a robust M&A-based growth strategy

Primary growth levers



- **Enhance core business**—Scale and consolidation plays can increase revenue and improve cost structure.
- **Geographic expansion**—M&A can help companies gain access to local market knowledge and produce market-appropriate products.
- **Adjacent market growth**—Adjacent market growth can be accelerated through M&A relative to “make” decisions.
- **Extend products and services**—Complementary products, services, or software can be accelerated.
- **New business models**—New markets created by developing technologies (e.g., home health, mobile health) may offset flattening growth in traditional segments.

When evaluating these and other strategic options, a medical technology company should consider a number of key questions:

- What specific segments, sub-segments, or therapeutic areas could create significant accretive value for our current portfolio over the next three to five years?
- Is our growth strategy better enabled by a “string of pearls” or a larger deal? What aspects of our internal capability may influence our strategy?
- What technology innovations could enable us to capitalize on patient and health care reimbursement trends? Are we sufficiently exploring early-stage medical device and technology innovations across venture capital-backed players and university research centers globally?
- Does our strategy include approaches such as partnerships, alliances, and licensing?
- How should our M&A strategy account for the entry of low-cost disruptive players, particularly in emerging markets? Should we view these players as threats or opportunities to adopt “reverse innovation”?

A strategy is only as strong as its execution, so medical technology companies should allocate considerable time and resources to develop or strengthen their M&A execution capabilities.

Preparing and executing on M&A strategy

As economic conditions continue to improve and deal activity increases, medical technology companies considering M&A can prepare and execute by focusing on a number of important actions across the transaction lifecycle, particularly in the areas of diligence and integration. As well, they should follow a structured approach to planning and execution that leverages leading practices and answers important questions such as:

- What is our M&A strategy? What implications does our strategy have on our needs for M&A competency (e.g., international, “string of pearls” versus larger deals)?
- What are the key value levers in these deals and what capabilities do we need from an organizational perspective to deliver them?

- Where are our historical strengths in the M&A process and across functions? Where would we be best served to enhance our capabilities?
- What activities must we get right during transaction integration? What are the “must-have” integration elements, and which are dependent on the deal?
- What organizational structure would allow us to execute most successfully? Do we need a dedicated team or is a virtual team more appropriate?
- What baseline do we have in place from an M&A capability standpoint? What can we build upon and what do we need to develop from scratch?
- Do we have the skills to build these capabilities? Or do we need advisors to help us?

Medical technology companies should look to enhance their M&A execution capabilities across three key elements, each aligned with the M&A strategy:

- **Develop an M&A playbook.** No single transaction will be exactly the same, but companies that follow a consistent approach and a checklist for diligence and integration activities generally have more success in meeting their goals than those starting from scratch each time.
- **Build an organizational capability.** This virtual or dedicated team working together on multiple transactions can leverage and enhance the playbook over time.
- **Use common tools.** A common toolset and approach can provide simplicity and alignment across a large (and often global) M&A execution team.

Similar to strategy development, diligence and integration execution should follow a leading-practice approach that recognizes the issues that may arise in a medical technology industry transaction. For example, in addition to the traditional diligence focus areas of quality and compliance, medical technology companies should consider the changing, reform-driven health care landscape and the resulting implications for product development, market expansion, and commercial models.

During integration, companies often need to stitch together a large number of complex elements—legal entities, ERP systems, supply chains, and more—while considering the implications across various customer segments (acute care facilities, surgery centers, outpatient sites) and third parties (group purchasing organizations, distributors). They must do this while retaining regulatory and quality systems to maintain business operations and deliver on expected synergies. And, with the significant number of medical technology carve-outs taking place, companies can expect increasing complexity as they seek to integrate product lines and partial businesses emanating from transition service agreements (TSAs). Mapping diligence and integration execution to the following leading practices can help companies facilitate a smooth transition (Table 1).

Bottom Line

The medical technology industry is facing numerous macro trends that are impacting the industry and the broader health care ecosystem. While M&A activity has been muted over the past few years, there are a number of factors that support a more positive view of M&A as a way to counter near-term organic growth challenges. This is evidenced by a number of recent M&A announcements, including the Zimmer-Biomet and Medtronic-Covidien deals.

Medical technology companies interested in pursuing M&A opportunities should get out in front of this growth curve by adopting a structured, holistic approach that considers their strategic growth goals as well as short- and longer-term industry dynamics—and by developing a strong M&A capability that leverages leading practices. In this way, medical technology companies can capitalize on core, adjacent and new growth drivers to extract more value from an evolving market.

Table 1: Leading practices to facilitate a smooth transition

Diligence

- **Prioritize the critical focus areas and define the value:** Focus on the risks and issues that are most important in the deal and the questions that impact value. Don't get bogged down in the details.
- **Establish a tight linkage between the financial deal model and the operational diligence findings:** Build revenue/cost implications into the deal model so that all teams understand what they are signing up for.
- **Develop diligence process quality and leverage/build an experienced team:** Gather a team of internal/external specialists, and build a competency over time.
- **Identify potential "deal breakers" at the start:** Obtain a clear understanding of non-negotiable items by functional area.
- **Define a high-level integration strategy and timeline upfront:** Develop the integration plan early to validate the deal rationale and timing.

Integration

- **Start with the end in mind:** Focus on the end-state design and develop a pragmatic, phased integration approach.
- **Create a common purpose:** Develop and clearly communicate the operating model and integration strategy.
- **Build a platform for growth:** Make strategic growth a priority and focus investment to support the growth trajectory.
- **Stabilize the workforce and retain key talent:** Communicate plans, seek input, and build consensus.
- **Emphasize synergy capture:** Drive rigorous planning and execution facilitated by aggressive targets.
- **Employ a robust, structured approach:** Establish and execute using a "command and control" program management and governance structure.

Table 2: Medical Technology M&A drivers and resulting activity by industry segment

Segment	Major Products	Market Drivers
Surgical Appliances and Supplies	Joints, orthopedic appliances, stents, surgical kits	<ul style="list-style-type: none"> • High prevalence of cardiovascular disease and orthopedic conditions • Increasing trend of home-based health care driving sales of home medical equipment (e.g., wheelchairs) • Growing number of ambulatory surgery centers • Increasing focus on reducing hospital-acquired infections, which could spur growth of infection prevention supplies
Surgical and Medical Instruments	Anesthesia, orthopedic instruments, optical diagnostic apparatus, syringes, catheters	<ul style="list-style-type: none"> • Aging population and growing number of surgeries for associated conditions • Increasing number of surgeries related to cardiac, orthopedic, and oncological conditions
Electro-medical and Electro-therapeutic apparatus	MRI machines, pacemakers, diagnostic imaging	<ul style="list-style-type: none"> • Growth of in-vivo diagnostic testing • Increasing use of implantable device-based treatments for cardiovascular conditions (pacemakers, defibrillators) • Increases in the number of hospital modernization programs, and the continuing expansion and diversification of the outpatient sector • Audiology equipment demand which is boosted by an aging population with a growing number of hearing-impairment conditions
Diagnostic Products (In-Vitro Diagnostic Substances + Irradiation Apparatus)	Chemical, biological substances, X-ray, diagnostic imaging	<ul style="list-style-type: none"> • Increasing focus on earlier disease detection • Technological advances and new product introductions • Expanded drug discovery and greater medical research capabilities, which create demand for more robust and accurate diagnostics
Ophthalmic Goods	Eyeglass frames and lenses	<ul style="list-style-type: none"> • High prevalence of vision impairments and volume of related surgeries
Dental Equipment and Supplies + Dental Laboratories	Drills, cements, plaster, dentures, bridges, crowns	<ul style="list-style-type: none"> • Shifting focus from repair to aesthetic procedures (e.g., ceramic fillings, and clear or tooth-colored orthodontic appliances) • More specialized demand for dental equipment, with high value-added computer-linked systems accounting for the best growth opportunities

*Definition of Medical Technology and segments involved in calculating market sizes may be different for US and global market (as two different source documents are used).

Sources: 1. "Medical Equipment and Supplies: United States," Freedonia, March 2014: 2. "A Consensus View of The Medical Device and Diagnostic Industry:" EvaluateMedTech. October 2012: Report from Scottish Enterprise on Medical Technologies Overview, 2011

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