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VIEWPOINT

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Lower Middle Market Medical Device M&A Trends for 2016

By Patrick West and Alex Camuzzi

M&A activity in the broader healthcare equipment sector was once again quite healthy in 2016. As in the past, most reporting on the deals in this space focused exclusively on transactions over $1 billion in enterprise value. Interestingly, the number of deals in the lower middle market (LMM), those under $400M, outnumber the larger deals by approximately 4:1 which is consistent with the previous five years. It is surprising then that there is a dearth of available analysis on the dynamics of these transactions. Given that the LMM is our area of expertise, this paper seeks to address this and provide insights into the dynamics of the LMM medical device space in terms of the most active buyers and valuations.

Introduction

Medical devices are a $148 billion industry in the US that has grown 4.5% CAGR annually over the past five years. While attention tends to be focused on the large brand name companies, of the 6,500 medical device companies in the US, 80% employ fewer than 50 people.

Over the past five years, the medical device space has witnessed remarkable consolidation of medium and large players.

This consolidation has been largely motivated by the benefits of augmenting a company's product portfolio (technology) and increasing negotiating power through enhancement of size and bundling of offerings (scale). The bundling of offerings proves particularly competitive when negotiating with healthcare providers.

The strategic growth plans of larger medical technology companies are often directed towards increasing scale and diversifying into higher growth technologies through acquisitions. Given that 2014 and 2015 were marquee years for large M&A deals in this space, it was assumed that 2016 would be populated by smaller tuck-in deals as companies continued to digest their recent large acquisitions. Although many tuck-in deals did in fact occur in 2016, the number of deals with transaction sizes in excess of $1 billion remained strong as well.

Materials & Methods

Our study began with the construction of a database that represents the entire population of LMM mergers and acquisitions in the medical device space, excluding sub-contractors and suppliers. We limited our search to deals over the past five and a half years, beginning on July 1, 2011.

The database contains 258 LMM medical device transactions where transaction values were available, of which 79 contained corresponding exit revenue multiple detail. It is important to note for the purposes of this analysis that we included milestone and other contingent consideration in the enterprise value of these deals in order to stay consistent with S&P Capital IQ's data, which is drawn upon throughout our research. Transaction details were further sourced and verified through the use of multiple publicly available databases. When enough data points were available, the transactions were categorized according to area of specialization. There were enough data points to break the data into cardiology, orthopedics and other. The “other” category includes deals in the fields of ophthalmology, urology, women’s health and dermatology amongst others.

Sector Performance & Market Metrics

An analysis of the public markets demonstrates that industry performance has been quite strong, with the iShares US medical device index, which contains 47 securities representative of the medical device industry, outperforming major benchmark indices. This is a trend we expect to continue.

Furthermore, public company valuations in the space have nearly doubled since 2011 with an average EV/Revenue of 3.8. The more acquisitive companies in the device space (Stryker, Medtronic, Bard, Boston Scientific) are all trading well above 4x.

The medical device industry has become more concentrated due to the number of mega consolidations that have occurred over the past several years.

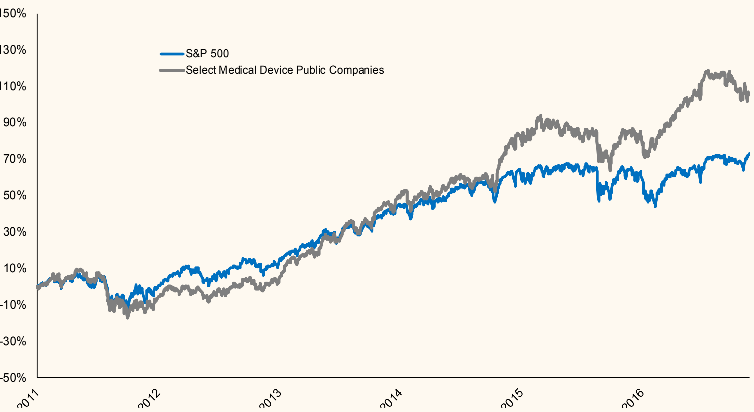
Notable among these was Medtronic’s $40 plus billion merger with Covidien that closed in 2015, and Abbott’s 2016 acquisition of St. Jude for $25 billion. The size of these mega deals, and the frequency at which they occur, give credence to the importance of scale within the industry.

Most Acquisitive Companies

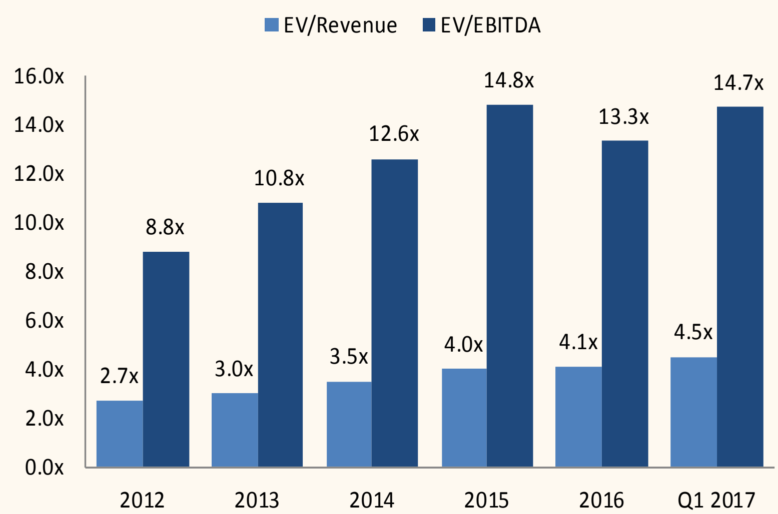
Those familiar with the industry will not be surprised that the most active buyers in the LMM space include: Medtronic, Bard, Boston Scientific and Stryker. Medtronic-Covidien continues its dominance atop the deal tables.

An interesting observation is the relative lack of activity from Johnson & Johnson (NYSE: JNJ). JNJ is fourth in device market share and one of the largest healthcare technology companies in the world. Analysts attribute JNJ’s lack of smaller deals to their unique capital allocation strategy that focuses on returning cash to shareholders.

S&P 500 vs. Index of Select Medical Device Public Companies



Medical Device Public Companies

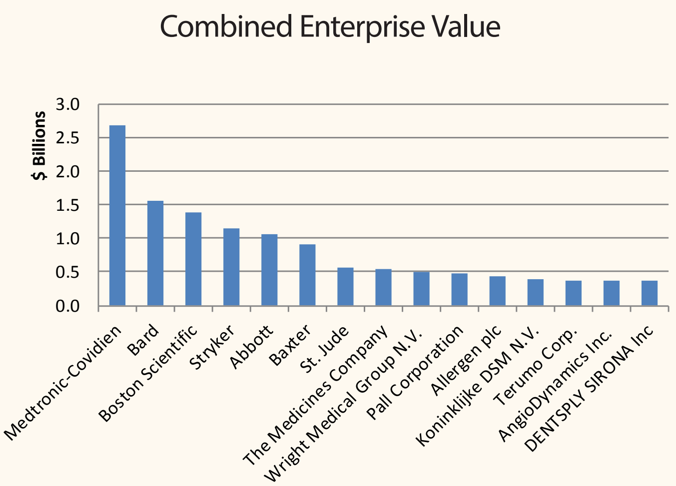


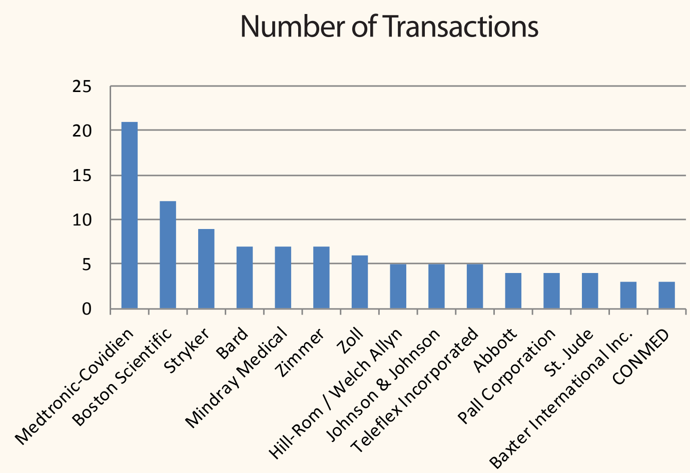
Most Aquisitive of Lower Middle Market Companies

Company Name	Number of Deals
Medtronic-Covidien	21
Boston Scientific	12
Stryker	9
Bard	7
Mindray Medical International Limited	7

This may be about to change, however, as more recently the company's CEO told Bloomberg: "History would show that value creation in large deals is much more challenging. Because we're more of an innovation- focused company, the ideal target company for us is early, great innovation, great science, then we scale it, versus going in and simply ripping out costs and trying to find other synergies." JNJ's has subsequently announced four LMM deals since the beginning of 2017.

Companies also tend to differ in their preference for number of deals versus size of deals, which is evident when comparing the list of most acquisitive companies to the charts below. For example, although Baxter completed $900 million of acquisitions, this was over three deals. This contrasts most strikingly to Medtronic, which spent $2.6 billion on 21 transactions. It is worth noting that the combined enterprise value chart may be somewhat skewed as companies are not consistent in publishing transaction data. As an example, while Zoll completed six transactions in this period, there is no publicly available data available on transaction values.





Acquisition strategies of the most acquisitive companies

The common trend among the recent transactions by these companies has been the motivation to grow horizontally by increasing product and service offerings and expand geographic presence, thereby capturing a larger portion of the global healthcare ecosystem. The larger companies, such as Medtronic and Stryker, are also chasing vertical acquisitions in order to achieve scale and operational efficiencies.

After a string of domestic and cross border acquisitions to expand product portfolio and international presence, Medtronic CEO, Omar Ishrak, recently indicated the company's intention to acquire companies that treat diseases in which Medtronic already has a presence. Company executives also said that they want to begin transitioning the medical technology giant into more of a health care service provider, using technology to help manage patient care from admission to outpatient follow- up visits. "We are steadfast in our focus on delivering long-term value in healthcare and believe there is significant growth opportunity for us as our strategies address the three universal healthcare needs - improving clinical outcomes, expanding access, and optimizing cost and efficiency," said Ishrak. "Aligned with these needs, our three key strategies will deliver new therapies, unlock opportunities in emerging markets and develop new solutions for hospital efficiency and disease management," he added.

Financial motivations for doing deals included tax savings and access to better cash flows. Ishrak also told investors at the Bernstein Strategic Decisions Conference, "[The Covidien deal] has really given us a significant potential for flexibility into the way we do capital allocation than we had before." The three primary ways that Medtronic plans to utilize these extra cash flows is for future acquisitions, dividends and share buybacks. Analysts also expect that combining Covidien's higher-growth business with Medtronic's operating efficiency will yield improvement in profit margins.

Following the theme of geographic and product line expansion, Boston Scientific executive vice president and CFO said at the Investor Day Conference in May 2015 "[w]e continue to broaden our geographic reach and diversify our portfolio into markets with compelling growth opportunities. We are entering segments within each of our markets that are projected to grow faster than the overall market over the next five years, and we expect to continue to diversify our portfolio away from 60 percent in slower growth markets in 2012 to 40 percent by 2019."

Commenting on Abbott Labs' preference for technology and innovation over scale, a Wells Fargo analyst in August 2015 said that "The company's strategy in medical devices is not to build scale for the sake of getting bigger or seeking operational synergies or bundling opportunities but rather to focus on differentiated technologies and platforms that can drive top-line growth."

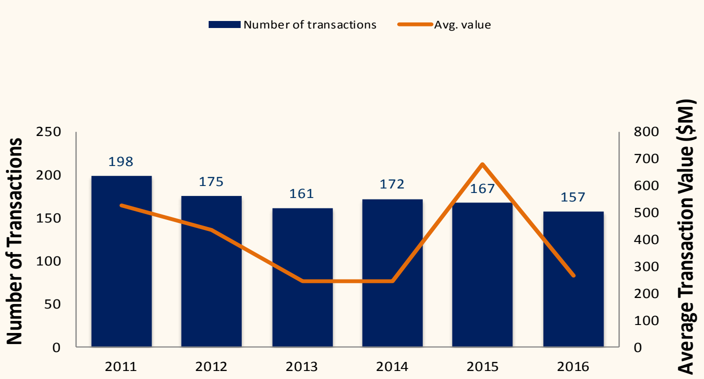
Stryker also remains bullish on future acquisitions. "What I have been consistently saying which is the first priority for cash is for acquisitions and obviously the timing of acquisitions is unpredictable. If those acquisitions don't materialize
in a reasonable period of time, then we would be open to larger share buybacks. So right now, we are pursuing the acquisition deal flow and we'll see what happens." said CEO Stryker Kevin Lobo in a January 2015 earnings call. Following the acquisition of Physio-Control in Feb 2016, Lobo told analysts during a call "One of the reasons to postpone the share repurchase program was to make sure we still have capacity, so this will not be the last deal that we do."

C.R. Bard, now an acquisition target itself, is another company that looks to remain active in the space. CEO Timothy Ring told analysts during an April 2015 earnings call that management was not content with the dearth of transactions for the company in 2014 and "There [are a] lot of things going on right now." Bard followed that up with its acquisition of Vascular Pathways Group of Companies in July and Liberator in November 2015. When interviewed regarding the liberator purchase, Ring chimed in on Bard's strategy to expand both across the globe and across the healthcare continuum; "This acquisition is a key building block in our strategy to access faster growing markets. As the population ages and more healthcare is expected to occur outside of the hospital setting, we believe that having direct access to the patient in the home is strategically important."

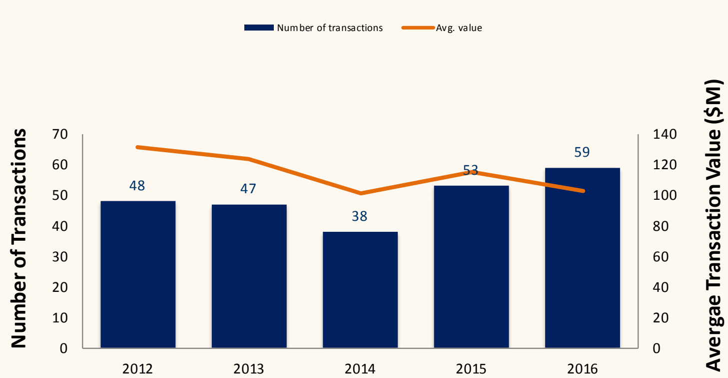
Lower Middle Market M&A Activity

A comparison of activity in the lower middle market device space to the broader healthcare equipment sector over our subject time period, suggests that both markets remain strong relative to the deal number and average transaction value standpoint with outliers in the broader market (such as 2015's Covidien, Carefusion and Biomet deals) at times skewing the average transaction size.

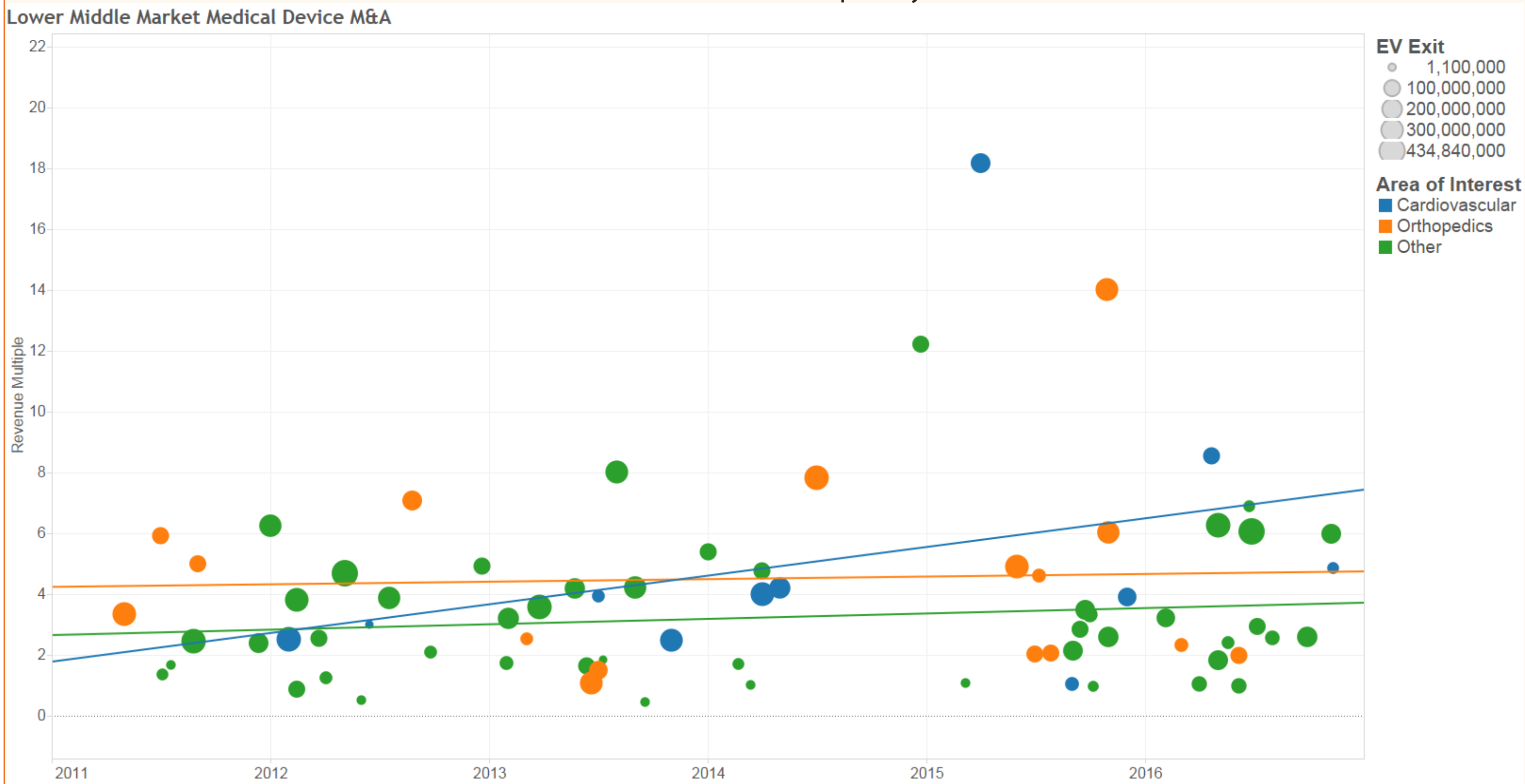
Healthcare Equipment & Supplies M&A



Lower Middle Market Medical Device M&A



Transaction Multiples by Sector



The plot of sum of Revenue Multiple for Date. Color shows details about Area of Interest. Size shows sum of EV Exit. The view is filtered on Exclusions (Area of Interest,Date), which keeps 74 members.

Transaction multiples by sector

Our data set support the notion that transactions in this space are primarily based on revenue multiples, with growth potential and strategic positioning being primary drivers of value. The relatively small number of EBITDA data points available in our data set support this notion. It would appear that this dynamic holds true outside of the lower middle market in many cases as well. Two recent examples are Zimmer's $1 billion acquisition of LDR holding at more than 6x revenue and Medtronic's 4x revenue, $1.2 billion deal for HeartWare – both negative EBITDA companies.

Over the past five years, revenue multiples in the space have exhibited an upward trend and that orthopedic and cardiovascular companies tend to command premium multiples relative to the "other" category. As discussed further below, we believe this upward trend may to some degree be the result of increasing demand at a time when there are fewer target companies available due to the reduction in available venture investment in the space over the past several years.

Lower Middle Market Med-Device with Revenue Multiples

	Cardiovascular	Orthopedics	Other	Total
Median EV/Sales	4.00x	4.61x	2.59x	3.48x
Number of Deals	13	17	49	79
Average Deal Size	$173M	$158M	$129M	$155M

An observation worth noting is that exit EV/Sales multiples tend to be higher for targets with higher (>$25M) revenue. This might suggest, that acquirers are willing to pay a premium for companies that have already achieved a degree of scale and maturity and thus are de-risked. An interesting challenge to this is the recent activity in the pre-revenue space.

Pre-Revenue Deals

An analysis of deals from 2012 through 2015 demonstrates a strong appetite for pre-revenue deals. Successful target companies in this group are often characterized
by significant capital investment (>$45M), experienced management teams, strong issued IP, first in man experience (perhaps some early beta sales) and regulatory (at times pending) approvals in the US and Europe.

Of the pre-revenue deals in our data set, 16 were in the cardiovascular sector. This represents over 57% of all pre-revenue deals and almost 25% of all deals done in the cardiovascular sector.

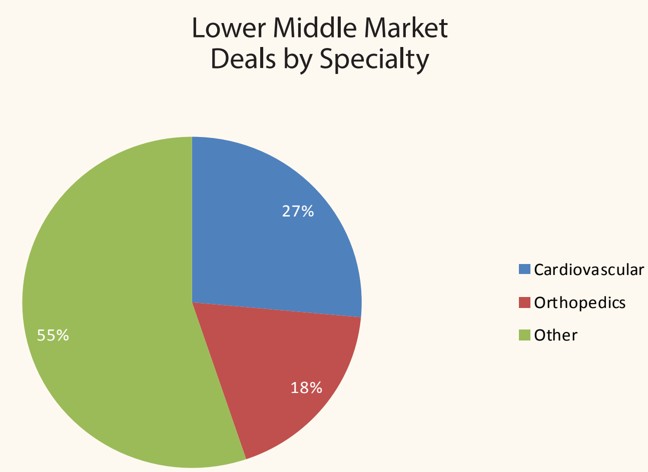
The average transaction value of these deals was approx. $168 million with deals ranging from $8 million to $380 million.

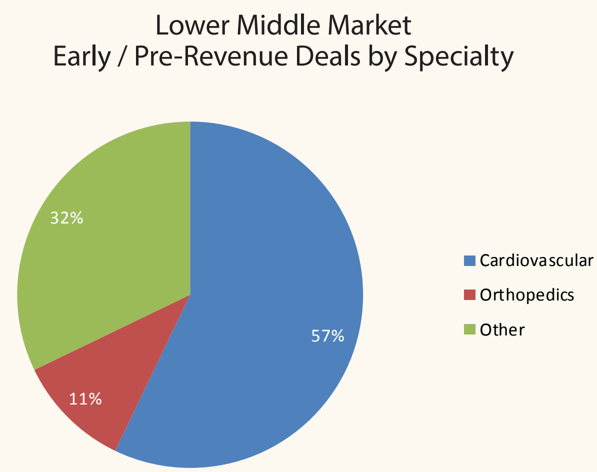
Trends affecting middle market M&A

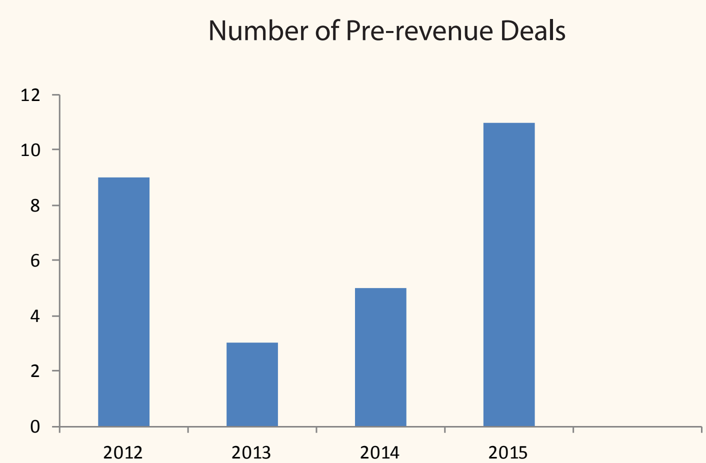
Medical devices funding challenges

Capital markets have been in a drought for medical device companies. It would appear that any IPO window that was open has snapped shut with just six medical device IPOs in 2016, with a median value of just under $27 million. In parallel, there has been significant reduction in available institutional capital for early stage companies with medical devices receiving less than 5% of all venture investing and a majority of this being larger rounds going to a smaller number of companies.

This creates an opportunity for larger companies with strong balance sheets and the right organization to invest in and drive development of promising technologies at very kind valuations as a supplement to their organic R&D efforts. The challenge however, is that this suggests that the number of more mature opportunities coming through the pipeline are diminishing at a time when acquisition is needed to fuel growth – suggesting that valuations may likely continue to rise.







Medical Device Excise Tax

The excise tax of 2.3% on gross sales was enacted as part of the Affordable Care Act on January 1, 2013. The tax was subsequently suspended for two years beginning in 2016 and, according to some speculation within the industry, it is possible that this suspension will be extended indefinitely.

The tax was expected to cost $210 million to Medtronic alone during 2016 and raise $29 billion for the US over 10 years. When enacted in early 2013, the tax most severely affected small and underfunded companies which lacked the scale necessary to absorb the hit to their bottom-line while still maintaining ordinary R&D expenditures. This made them prime takeover targets for larger players and increased consolidation in the industry.

The repeal of the medical device tax could boost profits by 1-5% annually and lead to higher multiples, but it remains to be seen how the full repeal of the tax will affect M&A activity.

CMS – Bundling and Safety

New rules that bundle all payments related to a patient's condition are aimed at simplifying medical reimbursements and increasing efficiencies. Originally introduced in 2013, these rules are now being expanded in scope and implementation. In April 2016, bundled payments were mandated for knee and hip replacements in certain cities. CMS has indicated its intent to have up to 50% of all Medicare payments under the purview of such payment models by 2018.

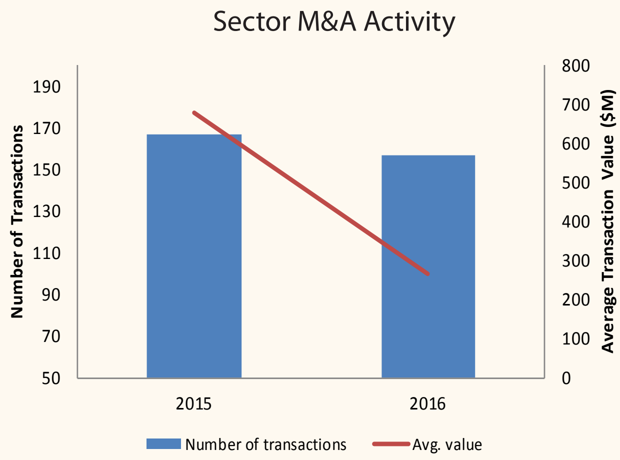
The implementation of such plans will encourage scale as a competitive advantage for obvious reasons and further drive M&A activity as companies attempt to build up critical size and diversify their product offerings within each category of ailment.

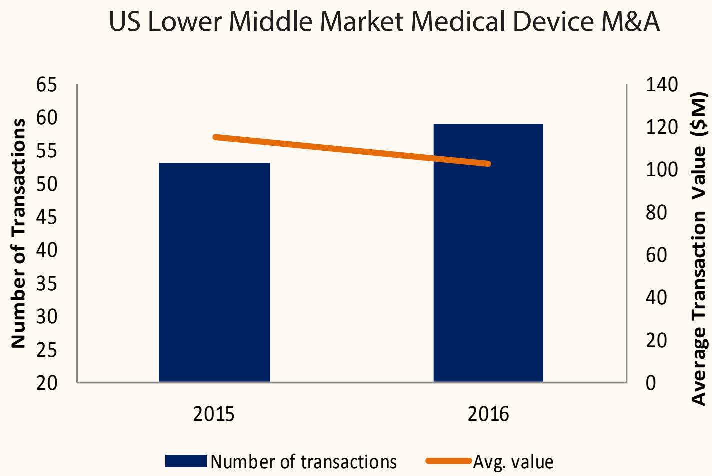
Additionally, CMS rules are driving hospitals to focus on outcomes and patient safety. Reductions in payments, or penalties, through CMS's avoidable readmissions, Hospital-Acquired Conditions and Value-Based Purchasing programs are expected to affect over 75% of the hospitals receiving CMS payments and may represent as much as $1 billion that will come right off their bottom line.

This is driving smart companies to look for tuck-in acquisitions that offer solutions to address these dynamics.

Consolidation of contract manufacturers

Though not covered in this research, it is worth noting that with the spate of large acquisitions over the past several years, that OEMs are now left with unmanageable supply chains and are having difficulties integrating the newly inherited post-acquisition suppliers with existing ones. Moreover, the dynamics of their relationships with contract manufacturers is also evolving as OEMs are now moving to full service contract manufacturers from the previous trend of choosing contract manufacturers based on the proximity of location. As result, recent mergers between OEM's are expected to have a domino effect of driving consolidation among the still fragmented supplier contract manufacturing base.





Summary: 2016 Performance and Future Outlook

Following 2015's trend, medical device M&A exhibited strong performance in 2016. Deal volume in the broader sector was nearly identical with average deal value trend being skewed by several of the mega-deals in 2015. In the lower middle market, we saw the number of deals increase by 11% to a five year high, with average transaction value slightly down.

The aggressive consolidation we have observed over the past several years in the med-device market has resulted in markedly larger companies. The Street's growth expectation for these concerns has not changed however resulting in a larger needle that needs to move just as much. With a limited number of large acquisition targets still available, and organic growth alone unable to satiate these expectations, the acquisition of small and medium size concerns appears to be part of most of these companies' growth strategy.

Based on these dynamics, we expect M&A activity and valuations in the Medical device space to remain strong in 2017.

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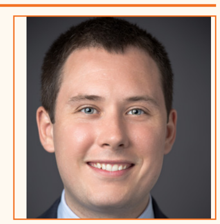

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