

## BUSINESS PLANNING & TECHNOLOGY DEVELOPMENT

### Roundtable: Medtech M&A

#### Industry experts weigh in on the current climate surrounding medical device mergers and acquisitions.

Moderated by [Steve Halasey](#)

Despite the ongoing credit crunch in the United States, there has been no shortage of mergers and acquisitions (M&A) activity among medical device manufacturers over the past year. However, the industry is not immune from the recent economic slowdown, which could have noteworthy implications for medtech M&A going forward. For this issue's roundtable discussion, *MX* called upon a panel of experts to provide their views about the current market conditions surrounding medtech M&A, as well as the sectors most likely to see continued consolidation in the coming years (see sidebar).

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#### **MX: Are the number and size of M&A deals in the medtech industry holding steady, declining, or rising? Are there identifiable causes behind the current trend?**

**Richard S. Cohen:** The medtech sector is reflective of the rest of the worldwide economy. It is being affected by the economic slowdown caused by the subprime mortgage mess; by the difficulty of packaging leveraged loans, which are the loans made to buy out firms; and just by overall recessionary pressures.



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Nevertheless, transactions are still being undertaken.

Overall, my sense is that acquirers are currently being less aggressive in seeking to grow by acquisition. Instead, they are being more defensive, more interested in fortifying their core operations. As in any crisis—even outside the medtech sector—the pendulum swings too far in one direction, and then swings too far in the other direction. In the past, some medtech deals were too speculative, and this has caused acquirers to become more defensive in how they're operating.

But having said that, in these dislocating times it's always important to prepare for the future. Companies that are well capitalized and forward-looking should be using this time to grow by acquisition as well as by more aggressive, organic means—and some that can afford it are certainly doing so.

**J. Casey McGlynn:** I agree that macroeconomic forces influence the medtech industry. Nevertheless, we continue to see a lot of companies in serious discussions, and our office is currently involved in a bunch of M&A deals involving a bunch of different companies.

So, in terms of acquisitions, I wouldn't say we're any less busy right now than we were a year ago. We don't know which deals will get done and which won't. But it certainly feels as though there is still quite a healthy medtech M&A market—even though the public markets seem to be more or less shut down.

#### **With regard to M&A activities, does the medtech field survive tough economic times better than other industries?**

**Ben Dunn:** In addition to our healthcare practice, our firm also has a technology practice as well as a consumer industrial group. Comparing our groups' M&A activities over the past six months, our healthcare group has remained strong, while the other sectors have experienced more of a downturn.

In the first quarter of 2007, 39 medical device deals were announced. By comparison, in the first quarter of 2008, 35 medical device deals were announced—a slight decrease. But what's more telling is that the 39 deals of 2007 represented a transaction value of \$15 billion, while the deals of 2008 are worth only \$7 billion. So even though a substantial number of deals are still getting done, these figures suggest that a lot of the bigger, higher profile deals are not.

Deals involving companies in the lower-middle and middle markets are probably a little more immune to some

economic conditions than are deals involving larger companies. And all of this is related to macroeconomic trends and to conditions in the stock markets and debt markets.

**Joseph E. Gilligan:** I agree that the medtech M&A market is as active as last year in many ways. But it's also a somewhat different market.

Obviously, mega-billion-dollar deals driven by price-to-earnings (P/E) ratios have kind of been pushed to the side. But strategic buyers are as active as ever—particularly among some of the big medtech companies. And quite a few interesting deals are being done in the price range from the hundreds of millions to the low billions of dollars. That's still a very active space.

Strategic buyers have plenty of cash. In the past, strategic buyers were somewhat marginalized by the valuations put in place by some of the P/E players. But strategic buyers are generally cash-flow-positive businesses, and they're aggressively looking around as much this year as last year.

**In terms of long-term trends, the current medtech M&A market probably still needs to be considered one of the most active in recent times. But where you have noticed a fall-off in activity, does it seem to be affecting different medical device sectors differently?**

**McGlynn:** We have done or are actively working on a number of deals in the spine area, in ophthalmology, in treatments for diseases of the bowel, and in women's health. These are all areas that continue to be very active in starting new companies, funding them, and selling them. We also continue to see a lot of things going on in the cardiovascular and related sectors, but perhaps fewer deals than five years ago.

We're doing a lot of things in those kinds of areas, but there's not really one sector that has a lot more traction than others. Instead, when I look at my portfolio of companies, the real determination is whether a particular company is at a right stage to be acquired. That decision is more likely to be made on the basis of anecdotal information, or the company's history, than as a result of sector trend analysis.

**Gilligan:** I would agree. The spine sector has been and remains one of the hot areas.

A lot of speculative ventures are being put together to pursue the holy grail areas of sleep apnea, weight loss, and weight management. In those areas, everybody views a successful product as being potentially transformative for a company.

Cardiovascular and general orthopedics may not be quite the dominant players they were a couple of years ago, but that's not because they're not still critically important and very big areas. It's just that other sectors such as spine have begun to grow.

And I also agree that women's health—including reproductive and breast health—is a very hot area.

**Some of those areas—women's health, sleep apnea, weight management, bariatric surgery and so on—seem to have one foot in the direct-to-consumer, home-use part of the market. Are you seeing companies make use of that approach to the marketplace in order to attain growth and become ripe for M&A?**

**Dunn:** We see the direct-to-consumer market as a big growth area. Considering the obstacles posed by reimbursement and other kinds of pressures, those types of companies can offer some very attractive possibilities. In general, a lot of medtech companies are looking at the healthcare trend in favor of more care occurring in the home rather than in the physician's office or other clinical settings.

Last year, we did about 10 transactions for a company called Inverness Medical Innovations (Waltham, MA), which is a diagnostics company that is working to bring diagnostic tests to the consumer and combine those with health services. Inverness has had a very active program of looking for companies and technologies that can help it fulfill that mission. So I think the direct-to-consumer approach offers some good opportunities, and will likely continue to do so.

**Over the past few years, a number of large companies have made strategic investments in smaller companies, negotiating up-front options for acquisition later on. Is that trend continuing, or are the other trends you've mentioned slowing it down?**

**Cohen:** First, let me say that I agree there is a lot of ongoing medtech M&A activity in the lower-middle and middle market areas—below the level of deals valued at \$10 billion or more. The market is very, very active at lower levels, and intensely active in the middle level, so I wouldn't say there has been a slowdown at all.

The model of large companies acquiring options or some equity component of a smaller company is well known and frequently used in the pharmaceutical and biotech industries. Now that it is also being used by medtech companies, I think that will become a continuing trend.

The reason this model is attractive is that even large companies need the creativity fostered outside their corporate culture, and they rely on the entrepreneurial efforts of smaller companies to develop niche or specialized products. Large companies often seek out products that are ready to be integrated with their own offerings.

The relationship doesn't necessarily have to involve an equity interest in the smaller company. It could be a

strategic relationship, an R&D relationship, or a sales and marketing relationship.

For instance, Boston Scientific (Natick, MA) recently completed the acquisition of a company called CryoCor (San Diego), which makes a cryoablation product for treating cardiac arrhythmias. The companies had previously collaborated under a development agreement, but CryoCor was having difficulty with its regulatory approvals. After the relationship became more meaningful to Boston Scientific, it decided to acquire the CryoCor product, so it negotiated the purchase of the entire company.

**Casey, what proportion of the deals that you get involved in have been set up by those kinds of strategic, early-stage investments?**

**McGlynn:** In the recent past, Boston Scientific has been the most aggressive player in the marketplace in terms of doing early deals, funding companies, and getting an option to acquire. Other acquiring companies also have lots of interest in investing in early-stage companies and doing various levels of complex deals that might lead to possible acquisitions.

But those deals are just the first step in a potentially multistep process. And historically, the start-up companies that do these deals have ended up being acquired—but frequently not by the same companies that entered into the agreements.

Although a lot of such deals might be possible, right now we're not doing many of them for the companies that we represent. The reason for this is that there's a great deal of venture capital available, and that makes it possible for companies to do deals that are a bit cleaner. And honestly, the people who own the biggest pieces of those companies—and those who are running them—would prefer to remain a little bit more pure—that is, not beholden to the influences of their large-company partners.

**Over the past year or so, the in vitro diagnostics sector has been significantly reshaped through major acquisitions, predominantly by large players from the imaging sector, such as Siemens. Are other sectors also being reshaped by mergers and acquisitions?**

**Gilligan:** Some of the recent transactions and big-company activities in the spine sector suggest that this area will be critically important for the future.

For instance, Kyphon's acquisitions of Disc-O-Tech and St. Francis Medical Technologies had an important roll-up effect on the sector that led to Kyphon's acquisition by Medtronic. Meanwhile, some of the smaller spine companies have really become just small independents, and fewer and fewer of those qualify to become real premium targets.

All of these activities are helping to reshape the spine sector.

**Dunn:** I agree. There have been a lot of developments in the spine industry. For a number of years, spine technology innovation was inadequate. But recently, some very innovative technologies have been developed. This has led to a bit of a battle among the larger players to see who can come up with the next-generation product, and who can stay ahead.

Turning back to last year, I think the merger of Cytec and Hologic has really reshaped the landscape in the field of women's health. That deal combined two women's health powerhouses into one company, and creates a dominant player in that sector.

**McGlynn:** In the sectors that we're talking about—spine, in vitro diagnostics, and women's health—the development of technology has really accelerated over the past few years. That's really the first-mover force here, and the interest of the big companies is really just a response to these changes in technology.

Advances in technology have radically changed the way we look at diagnostics in general, and in vitro diagnostics in particular. And along the way, a lot of the companies in those sectors have become very important acquisition targets. And the same is true for the spine sector and for women's health, as those businesses have matured.

This is just a different way of looking at the same trend. But I definitely agree that the sectors we're discussing are important, and they are also sectors that the big companies like.

**In the IVD sector, some of the acquired companies have been among the largest in the business. But the more typical model is for a start-up company to grow to maturity—however that might be defined—and be acquired by a larger player. Are both of these kinds of M&A deals going on simultaneously? How long can the market sustain both levels of activity?**

**Cohen:** The model in which a start-up company develops, gains traction, proves its value in the marketplace, and attracts the attention of a larger acquiring company will remain forever.

But of course there is a limit to the number of deals involving large company targets. There have been so many megatransactions in the past few years that the market has become more concentrated, and there are now fewer large companies to combine. In addition to current economic conditions, this also helps to explain why fewer large deals are being done now. In effect, many of the really big deals that are logical have already been done.

Today, large companies are considering potential acquisitions far more strategically than they did in the past. In the bigger transactions that we're doing, the corporate chain of command is imposing a much higher level of scrutiny to prove that the acquisition fits in well with the company's core product lines. Those companies are venturing less far afield than they might have in the past. There may be some interest in diversification, but only in complementary areas.

**Dunn:** The medtech company life cycle in which small companies are sold to larger companies has been going on for years. And considering the high level of venture capital funding available to support the creation of new medtech ventures, that life cycle will go on for many more years. Over time, the number of small deals moves along at a pretty steady pace. That's how it goes.

For larger deals, the issue is simply one of supply and demand. There are only so many large companies in certain medtech sectors. The supply of companies and potential deals may be subject to some cyclical pattern, but for the foreseeable future I think we'll see a downturn in larger deals.

**Gilligan:** The medtech industry's life cycle is well known. Start-up companies move an idea through development to initial commercialization, and then they seek to be bought. For most companies there isn't an alternative path, because the costs of recruiting and maintaining independent sales forces and distribution channels and networks are just prohibitive. That ultimate obstacle remains the same as it ever was—with the same effects on company growth.

For large-company deals, another factor to consider is the valuations involved in those transactions. Large medtech companies are being very careful about accepting valuations that have been in the market for the past couple of years. Before committing to such a large and expensive acquisition, companies really have to be able to justify and rationalize the economics of the deal.

In this regard, it would be difficult to overemphasize the impact of Boston Scientific's acquisition of Guidant, and the tough times that Boston Scientific has had since that deal was consummated. There's no question that this example has made many of industry's largest deal participants very careful.

### Economic Implications

**Although medtech companies may be faring slightly better than those in other industries, the tightening credit situation has to be on the minds of company executives almost constantly. When they are starting to do a deal, what specific concerns do medtech executives find most disturbing? For instance, are they most concerned about the complexity of the deal requirements, the simple unavailability of credit, or what?**

**Dunn:** For large deals, current market issues include any transactions that require debt financing. We're in the market right now with a deal that requires debt financing, and difficulty in obtaining it is causing a real hiccup in the negotiations and the ability of the buyer to pay, so the debt markets are a major issue right now.

Another factor is a higher level of due diligence, especially among strategic buyers. The buyers want to make sure that the deals really do fit and make sense. And a lot of those companies need to be sure that their deals will be accretive immediately or in the very near term.

Strategic buyers don't want to do a deal for which Wall Street might penalize them—whether because of lost earnings, not making business sense, or simply for doing a poor job of articulating why they're doing the deal.

**When it comes to putting deal terms on a page, is this new sensitivity resulting in new and different kinds of terms? I've heard companies refer to reverse termination fees, for instance, with regard to their deals.**

**McGlynn:** Most of my deals are sell-side, involving small to midsized companies, so I generally don't see the impact of the credit markets. In most of our deals, the acquirers have already decided to go through with the transaction, and our task is to negotiate the deal using some set budget facts—and credit isn't typically among them.

**Cohen:** We are in the midst of managing the bidding for the sale of a company. Among the bidders were a number of operating companies and a select group of private equity firms. Generally speaking, the operating companies expressed few issues with credit financing.

However, private equity firms are complaining that their lending sources are raising the bar in terms of scrutiny. And the accounting firms that are performing due diligence are certainly reviewing our client's operating results and EBITDA adjustments, and we expect this review to be rigorous.

We have learned that sales prices as a multiple of earnings are a little lower when the acquirer is a private equity firm. So, at least temporarily, we are tending to steer transactions in the direction of strategic buyers for which the deals may be more compelling and valuable.

**Dunn:** Our experience has been in larger deals, where it has been necessary to factor in the credit markets. Smaller deals for which an acquiring business or financing source has cash available don't have to overcome

quite the same hurdles.

I agree that there is a new, added level of due diligence. We're not seeing companies incorporate new terms in their agreements or letters of intent. However, we are seeing the level of due diligence being elevated to new heights.

**Over the past year, currency exchange rates have had some significant effects on company earnings—both positive and negative. Do currency fluctuations also have an effect on M&A activities in a given region? Because of the weakening dollar, for instance, is it easier and more attractive for overseas investors to acquire U.S.-based companies?**

**Gilligan:** Absolutely. We are seeing much more activity now. The interest is coming primarily, but not exclusively, out of the Euro zone. For all of the sell-side transactions that we undertake, our financial advisers and others ensure that there is exposure to and significant participation by some of the major Euro zone companies.

Although sovereign wealth funds are becoming active investors in a lot of industries, we haven't seen them express interest in the medtech space yet. That's partly because the medtech sector isn't ripe for smaller-level strategic investments by those funds, particularly if they don't have significant industry expertise.

**Is that foreign interest helping to support pricing of some medtech deals?**

**Gilligan:** It's both helping to support the pricing and, frankly, just helping to get the deals done. Every auction takes on a different feel when there's more than one participant.

**Cohen:** It's hard to generalize, but we tend to involve foreign buyers in every transaction in which we represent the seller—because of the weak dollar and the opportunity for a foreign acquirer to establish a U.S. platform.

This is a multidimensional issue. Because of the weakness of the dollar, American companies are less expensive for non-U.S. companies to acquire. In addition, foreign companies' products are becoming harder to sell in the United States because they're more expensive. So, foreign buyers are even further motivated to make an acquisition here. In some ways, the United States has become a low-wage country, realtively speaking.

At least in our transactions, however, I think acquirers have been careful not to let currency benefits eclipse the core fundamentals of the deal. So other considerations definitely have a play there. American companies might benefit from exchange rates, but I don't think current conditions are enabling any deal to happen that wouldn't otherwise pass operational muster.

**Last year was a record period for venture capital investment in early-stage medtech companies. Most such VC-funded start-ups assume that their eventual exit will be through an acquisition. In the current economic environment, is this still a logical path for start-up companies seeking to reward their early investors?**

**McGlynn:** Most of the companies that I have represented in the medtech area have been sold; they have not gone public. And even those that have gone public—such as Kyphon—have eventually been sold. So in almost every case, eventually these companies are going to be acquired.

But even though the IPO market is closed today, now, more than ever, medtech companies believe that they will be able to go public if that's what they want to do.

For a long time, it was just very difficult for medtech companies to commercialize their products successfully without having been sold to a big company that would control distribution. But today, we see a lot of successful companies commercializing their products and building revenue. And that makes company executives believe that if they were to get to about \$25 million in sales, with a good growth rate, it might be viable for the company to launch an IPO.

So that's the kind of thinking that is common among most medtech CEOs and VCs right now—even though they all know that the most likely exit is going to be through an acquisition.

But even on day one, entrepreneurs who start medtech companies today are certainly thinking about what their exit strategy will be. Many such start-ups, for instance, are established in order to bring to market a breakthrough product that will require a long development cycle and regulatory review via the premarket approval (PMA) route. Getting such a product to market takes a lot of time and money—perhaps more than \$100 million.

It is definitely within the ability of today's VC community to finance such a venture. But from the entrepreneur's standpoint, accepting that much VC funding would mean there's going to be gigantic dilution.

So a lot of those guys start companies with the goal of achieving an early exit. Their strategy calls for moves to generate demand very rapidly, and then to sell to mid-tier players—preferably while earning a handsome return. This early exit scenario avoids the need for the start-up company to spend a lot more money to get regulatory approval and commercialize in the United States before looking to an acquisition.

**At some point during the development of a start-up company, company leaders need to decide when**

**they will try to make an exit. What do you tell these executives about how to attract the attention of potential acquirers?**

**Gilligan:** Executives who ultimately hope to engage in a sale or IPO absolutely cannot spend enough time getting their companies' IP in shape. Companies must be able to demonstrate that they have strong and enforceable IP.

An inadequate IP portfolio is the number one failure that trips up medtech deals. And, I believe, it's also the number one factor that buyers are worried about.

A company might be able to complete a deal on the basis of valuation. But if it can't demonstrate that its IP is ready for prime time, then the deal's not moving forward.

**Dunn:** Compared with companies in the past, a lot of companies today are already smarter when they're starting up. They are already thinking about their ultimate exit and putting measures in place so that when the time comes to make an exit, they've got alternatives.

We always stress that in order to maximize company value, it's best to have as many alternatives as possible. Having alternatives might mean keeping a cash reserve so that if buyers aren't forthcoming, the company can always go it alone. It might also mean taking steps to make the company attractive to a group of potential acquirers.

We advise companies to ensure that they have a very strong and focused IP portfolio, rather than broad IP holdings that cover lots of different markets. Taking this step will help to ensure that the company's value proposition is very easy to understand.

We also advise companies to make sure that they have gotten on the radar screen of larger medtech companies, so that the company's presence is known and understood and can quickly be evaluated.

**Joe, what has been your experience in valuing an acquisition target during the period before its products are commercially available?**

**Gilligan:** That is probably the single toughest challenge for valuing medtech deals, because in some cases the company may be not only prerevenue but also pre-FDA approval. We have situations in which we're selling the company either prior to the start of clinical trials or while the trials are in progress. Either way, valuation is extremely difficult.

The results of every valuation model depend entirely on the assumptions that go into creating the model. So of course the assumptions that we use are very important. For medtech companies, a lot of those assumptions depend on getting a good view of the regulatory pathway and its timetable.

**McGlynn: There are several strategies that a company can use to improve its valuation.**

Obviously, the company's IP is an important piece in the valuation chain.

But companies also need to know everything possible about all of the companies in the marketplace that are like themselves. This is important, because inevitably companies will be asked to demonstrate how they are more worthy than those comparable companies. So company leaders have to know what other companies are developing competing technologies, how the two companies' technologies compare with one another, how long it will take the competition to reach market, and so on.

And finally, companies should devote time early on to building strong relationships with the key opinion leaders in their particular market segment. Those relationships can help to ensure that the company is viewed as a leader in its field. And that kind of recognition, in turn, makes all of the big companies pay attention to the company when they are hunting for that kind of product.

### Attracting Attention

**You've all talked about the buy-side increase in due diligence and sell-side interest in building value quickly for an earlier exit. In almost any deal, it seems like those two trends would butt heads with one another. Are there particular characteristics that would enable a potential acquirer to determine whether a company is ripe and the deal is ready to be done?**

**McGlynn:** In most situations, the key factor that an acquiring company should consider is the seller's state of commercialization. It's very important whether the selling company has launched its product and has begun to experience good, rapid adoption in the marketplace—especially if there's a lot of enthusiasm by the doctors who are using the product. These are all important facts that a company should seek to promote when trying to sell itself.

For most of the companies that we're involved in selling, the most important pieces of information are those centered on the company's state of commercialization—market size, growth rates, and so on. This kind of information is especially suited to supporting the sale of a company with a commercialized product, and it's very different from the approach that might be used by companies pursuing an early exit strategy.

**Cohen:** A small company can't be all things to all people. So one of our mantras for developing companies, whether they are prerevenue or revenue-producing, is to specialize and focus on fundamentals.

On a high elevation, we've seen early-stage companies focus on—or maybe unintentionally espouse—frilly promotional activities using a lot of pizzazz, smoke, and large trade show displays. They talk about the large size of their product's potential market, and then claim that they will be doing swimmingly when they have captured just 2 or 3% of that market.

But we advise developing companies to focus where the rubber meets the road: on the core sales relationship between a device company and a doctor. And to be successful in this realm, companies must be able to demonstrate clinical effectiveness, to show time and cost savings to the healthcare system, and to offer evidence that their products can help get patients out of the hospital quicker. And along with these demonstrations, companies must also take steps to obtain reimbursement coverage, which has a direct effect on their profitability and that of their customer accounts.

Other company characteristics are also important. The status of the company's patents has already been mentioned. The company should show that its product can be made cost-effectively on a high-volume basis so that an appropriate gross margin can be obtained. And the company must also address the whole issue of supply-chain logistics and distribution.

**A lot of what you've just said seems to push acquisitions further downstream—the opposite direction from where sellers seem to be wanting to go. If that's the situation, at what stage do deals really happen? How do early sellers find a meeting ground with late buyers who expect both commercial adoption and significant clinical performance data?**

**Dunn:** Historically, deals have happened at almost every point in company development. But one of the key points is when the company's product receives regulatory approval.

At that point, there's a major shift in the risk dynamic for a potential acquirer. So it's logical that the greatest number of deals would take place shortly after regulatory approval—say, within a year of that mark. If you were to graph medtech acquisitions on a bell curve, the majority of deals would happen within a year or two of regulatory approval.

**How do prospective acquirers track and evaluate start-up and emerging companies during their earliest phases—before they have regulatory approvals or commercial products?**

**McGlynn:** Of course the largest companies have a lot of business development people whose job it is to find out what's going on in industry. So they attend and watch presentations at major medical conferences, and they review interesting new science seminars and poster sessions that are presented at those meetings.

Creating those kinds of presentations is one of the goals for small companies that are pursuing an early exit strategy. They are eager to partner with key researchers who will conduct early animal and human testing and then take the podium to talk about this developing technology and how it works. These presentations get doctors to begin thinking about the product. And they also get other people interested in this newfangled way of performing a particular procedure.

**What about companies that aren't pursuing an early exit strategy, but still want to optimize their opportunities for a profitable exit?**

**McGlynn:** Companies have to choose their strategy pretty early.

Many companies aren't interested in being sold early, so they don't feel obligated to create public or professional awareness in their earliest days. But even those companies face a choice: they can either keep as quiet as possible and wait until they are ready to create a big splash, or they can try to pursue an approach that makes more strategic use of company communications.

In the latter approach, companies try to develop relationships with all of their possible acquirers very early on. Efforts are made to have the potential acquirers review the company's early animal and human clinical research, and to encourage the acquirers to follow the company in a very collegial kind of way.

Obviously, there are some risks with this approach. Early in a company's lifetime, for instance, the company's IP is not yet ripe or mature. Special measures may be required to ensure that proprietary information is not inadvertently revealed.

One good thing about the strategic communications approach is that it can provide a basis for creating signposts that help to give the company a more recognizable profile among medical device companies. Large medtech companies that are potential acquirers often have to sort through a lot of market noise in order to identify the much smaller group of start-up companies in which they might have an interest. By using a signpost strategy, start-up companies can help to ensure that potential acquirers can pick them out of a cluster of 25 companies that are involved in the same field.

A company can establish one useful signpost by picking world-famous scientific and clinical advisers. Potential acquirers will recognize and remember companies whose advisers are acknowledged as being really smart, really well known, and really well connected with all of the players in that business.

Another signpost can be created by picking venture capitalists that are the best and the best known—people who have been in the business for a long time and have lots of relationships. Large companies may have to sort through a group of 25 companies to figure out which ones are worth spending time with. That decision becomes easier when they see that a company has a relationship with a VC firm whose partners are considered brilliant, because those VCs wouldn't invest in a stupid company.

Adopting a signpost strategy is absolutely critical for building credibility and relationships among start-up medtech companies and their large-company counterparts.

**Cohen:** Another way that large-company acquirers can keep track of developments in their field is to stay close to the clinicians or surgeons who are most active in the area. In almost every medical specialty, subspecialty, or emerging research area, there is a small group of key opinion leaders whose experience and expertise can sway many others. Business development staff from large companies can learn a lot by visiting clinics or being in the operating room to speak with these opinion leaders while they're working on procedures. They should seek to be fully ingrained in that community.

Correspondingly, if there were a single place where start-up companies need to make an imprint, it would be there. Start-ups definitely need to seek out key opinion leaders and develop specialized opportunities for working with them—whether in preclinical studies, small clinical trials, or other means. The route may be indirect, but influencing these leaders of the clinical community is an important way that small companies can get the attention of large-company acquirers operating in the same niche areas.

And, of course, small companies also need to make regular presentations at investment conferences, including angel events and conferences sponsored by investment banking firms.

**Richard, how does your firm track emerging companies that might eventually become candidates for acquisition?**

**Cohen:** We're not stock analysts or investment bankers, so our tracking tends to be related to certain companies that we consider prospective clients.

In terms of our *Strategic Healthcare M&A Report* and other materials we publish about industry M&A activities, we never use any information that we have until there has been a public announcement. Even if we found out about a transaction by buzz, we wouldn't say anything about it, just as a matter of propriety.

### Acquiring Minds

**Some companies approach mergers and acquisitions with strategic goals in mind, as has already been suggested. But other companies favor a diversification approach, as in the case of the imaging companies that have recently been going after IVD businesses. Which of these approaches is most common? Are most companies pursuing a strategic approach now, or are they looking to expand into new areas? Which approach has the greatest potential under likely market conditions going forward?**

**Dunn:** The strategic approach is probably the easiest and most common one, because it permits buyers to stay within their core focus and product areas. Deals of this type generally involve technologies and products that the buyer understands, and there is usually a ready champion for such deals within the company. Moreover, companies can develop a lot of synergies out of strategic deals. Historically that approach has been very strong, and will continue to be so.

The diversification strategy is interesting. Many large medical device companies have reduced their R&D budgets so that they are not conducting development activities internally at the same rate as they did in the past. As a result, in order to come up with new ideas in new areas, those companies need to do acquisitions.

Despite such a strong need, it is still hard for companies to justify acquisitions that take them into new business areas. Although diversification acquisitions will happen, companies will probably impose an extra level of scrutiny that will have to be accomplished as part of any diversification move.

It's important to note that public companies have to be very careful how they articulate their diversification strategy to Wall Street and others in the investment community. Otherwise, the company's share price can really take a hit. Over the past few years, a couple of companies have tried to implement diversification strategies and perhaps didn't communicate them well. As a result, the companies' moves weren't well received by investors.

**In some companies—Johnson & Johnson and GE Healthcare come to mind—almost all growth seems to come out of that complementary acquisition area.**

**McGlynn:** I would add a couple more examples. Abbott's move into devices generally—and then into the specific sectors of cardiovascular, diabetes, and orthopedics—were all diversification moves conducted by the company over the past 10 years or so.

Medtronic has also made some big diversification moves, adding capabilities in the ENT area and also in diabetes, through the acquisition of MiniMed.

Large medtech companies share a huge problem, which is that their growth rates have slowed down. As a result, their stock prices look pretty moribund. For some of these large device companies, diversification is probably the only way to reignite sales growth.

But most of the mid-tier companies pursue a much more focused acquisition strategy. A good example is last year's merger of Hologic and Cytyc, bringing together all of the work those two companies have done in the women's health area.

Most of the acquiring companies that we see are interested in strategic purchases of small start-up companies. They're not usually looking for diversification plays.

**Are some device sectors better candidates than others for that kind of diversification deal? For instance, do large companies actively look for diversification in certain sectors that they think might become hot? You've all mentioned spine products as a hot area, for example, but none of you have mentioned neurotechnology.**

**McGlynn:** The neurotechnology market is really interesting and potentially very valuable. There may be some good stories related to neurological monitoring devices. But for other types of neurodevices, it's still a very small market in many ways.

Take Target Therapeutics as an example. Boston Scientific paid \$1 billion to acquire the company. And even though it is a very profitable unit, it is still a very small company.

And even when you take in all of the companies that are active in the neurodevice area, the number of products remains somewhat small. I'm sure that the neurotechnology area has huge potential, but so far it just hasn't exploded. On the device side, I just don't think we've figured out how to crack that market yet.

**So that's not a sector that's ripe for the complementary diversification strategy yet.**

**Cohen:** We have to be careful how we're defining *diversification*. One model would be similar to the AOL/Time Warner merger, in which two disparate companies come together with some forward-looking vision, and try to identify synergies.

But in the medical device industry, diversification is represented by smaller moves into areas that might be considered complementary. Recent examples include Medtronic's acquisition of Kyphon, giving the company new capabilities in the spine sector. Or Olympus, an endoscope company, buying Gyrus Group, a minimally invasive surgical instrument company.

These somewhat small complementary moves are very different from a large-scale diversification strategy. A better example of the latter would be when Bristol-Myers, a pharmaceutical company, bought ConvaTec, a wound-care company. It's arguable that cross-sector diversification strategy never quite worked out for those companies, which explains why ConvaTec was recently divested to Nordic Capital for a little over \$4 billion. Instead, Bristol-Myers Squibb is returning to the strategy of focusing on its core competencies, as indicated by the fact that it has already acquired a cancer therapeutic company.

So I think a lot of the diversification acquisitions among medical device companies are really just moves into neighboring or complementary areas in which the companies already feel comfortable.

There are a couple more elements to be considered, and those are geography and emerging markets. Weighting geography in an acquisition may influence how a company can manage its supply chain and whether it will be practical to manufacture products in low-wage countries. And they may also determine the feasibility of moving into new regional markets, perhaps using an acquisition as a platform for opening up emerging markets to new products.

So in addition to diversifying or acquiring companies in related lines, companies can also consider the growth implications of acquisitions conducted to build new geographic markets.

**The area that has come to be called convergence—biotech, medtech, and pharma companies pursuing common cross-sector interests—has attracted a lot of attention over the past few years. These efforts mostly involve partnerships, alliances, joint ventures, and similar arrangements. But are they also likely to lead to cross-sector mergers and acquisitions?**

**McGlynn:** Convergence is a complicated area because it means more dollars and longer development time to market. And most of the markets for converging products are tiny compared with drug-eluting stents. Life sciences convergence started with the blockbuster. Because of that, people make the mistake of thinking that every time we add a biologic to a device, it'll be some wonderful new product with huge potential that's easy to get to market.

If you look at the start-up level, the companies focused on convergence are not that healthy. These companies take tons of money and a long time to develop. So I think it will be the exception rather than the rule when you see a convergence strategy result in great success stories.

But despite my negative view on convergence, obviously there's a lot to be said for enhancements that make a device more effective. In cases where convergence achieves that, it'll be great.

There have been a couple of acquisitions directed at the convergence space. After Boston Scientific, Angiotech had so many failed experiences in the convergence space that the company ended up buying a medical device company. And you see how well that went.

Another drug-eluting stent company, Conor, was acquired by J&J early in the game, and the merger was a disaster for the company. So I'm a little bit cynical.

**Dunn:** The convergence area gets a lot of press and seemingly shows great promise. But, in reality, there haven't been a lot of deals done in this area.

Stryker Corp. (Kalamazoo, MI) bought BMP-7, which is a drug for the company's orthopedic implants. There have also been some smaller moves in this area. Overall, device companies and therapeutic companies have run into some major cultural challenges when they've tried to work together. At a device company, the time to market is much faster than at a therapeutic company. Due to this discrepancy and others, the joint development teams that device and therapeutic companies have put together haven't worked out very well.

Life sciences convergence will continue to get press, we'll probably continue to see some movement in that area. But I don't believe that area is going to move as fast or as significantly as everybody thinks.

**Cohen:** Yes, I agree. The transdermal drug-device market has been advertised for 10–15 years as being a major new market. And frankly, only now is it becoming more productive. Companies are treading carefully when it comes to convergence opportunities.

One area of convergence that is taking shape is that of patient monitoring and information technologies. This convergence encompasses healthcare records, telemedicine, and the ability to access information from patient-monitoring devices through enhanced information technologies. It doesn't constitute a drug-device convergence, but it's an example of where industries are merging to create more-effective products.

## Looking Ahead

**How will the market for medtech M&A deals change over the coming year? How will market conditions affect the number or types of deals ready to be consummated?**

**Cohen:** In the middle market, the M&A landscape is going to be as active as ever. With certain exceptions, that market is relatively immune from broader economic conditions.

I think we'll be seeing fewer mega-billion-dollar deals in the near term than we have in recent years. That will in part be due to the current state of the credit markets. But also, as a company becomes larger, it may be less likely to find a fit with an even larger acquirer. So private equity firms, such as Kohlberg Kravis Roberts & Co. and Blackstone Group, come in to ramp up those larger companies even further.

Multi-billion-dollar deals will continue, but I think there will be a private equity bias there. And there will still be a lot of activity in the middle market.

**Dunn:** As we look forward 12 months from now, we'll probably see a slight drop in the number of deals over the previous year. But that's not necessarily surprising, as the medtech market's been going at a pretty torrid pace lately.

There's still going to be a steady number of deals done. The deal values will decrease, but there will be consistent activity in the lower-middle market, with fewer megadeals on the horizon.

**McGlynn:** I think Richard and Ben have said it all. I definitely agree with both of them.

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