The Walden Group
560 White Plains Rd
Tarrytown, NY 10591
www.waldenmed.com

Building Fundamental Business Value – The Value of Seeing Your Business Through an Acquiror's Eyes

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By Merle Symes and Richard S. Cohen

All senior managers are tasked with the objective of building fundamental business value. However, there is no simple guide.

With the sluggish economy and higher co-pays and deductibles holding down healthcare utilization, the demand for healthcare products has hit a speed bump. Add to this a tougher FDA process, tighter government and hospital budgets, lowering reimbursements and a cloudy healthcare reform picture … and you have major challenges in building fundamental value.

Managers of publicly traded firms are keenly aware of their stock price and market cap as measures of shareholder value. Yet, even public companies can focus too rigidly on their constituent product lines and initiatives and lose sight of the wider market and bigger picture. Principals of private companies are in a more difficult position without public market valuation tools as feedback of their efforts. Managers in all companies run the risk of confusing meeting short-term milestones and quarterly targets with building fundamental value.

Buy Your Own Business

In our work with various management teams, we have found a useful exercise to help achieve a deeper understanding of their businesses -- analyze the business as if you were an outside buyer planning to buy it. This provides a unique insight on how outsiders would value the company and can serve as a guide to building fundamental value. This exercise also applies to divisions and product lines of public companies.

If done dispassionately and preferably with the aid of a skilled outside professional, this exercise will help you look at your company with a wider perspective and ask some hard questions. "What are the key assets of this business that would be of value to others and how can we build on those assets?" "What assets would not be valued by others because they are not contributing adequately to the business?" "Are we investing too much in maintaining existing businesses and stagnant lines and not enough in future growth potential?" "Is it practical to undertake every initiative independently or would some collaborations help grow the business on a quicker and less risky basis?"

It is common to see private equity and venture capital firms acquire businesses or product lines firms that are languishing and then redirect the strategy to successfully build fundamental value. Often, the underperforming assets are privately-owned and the principals lack the wherewithal to unlock the value. In contrast, managers of large public companies find their focus drawn to achieving quarterly results and meeting analysts' expectations which often obscures the attention needed to build fundamental value. Financial sponsors can come in with fresh eyes and are not tied to the businesses of the past or the distractions of meeting short-term expectations.

A prime example is Smith & Nephew's 2006 sale of the Dermagraft and TransCyte regenerative medicine product lines to Cannaan Partners after failing to win FDA approval for the treatment of venous leg ulcers.

The new company -- Advance BioHealing -- redirected the skin substitute technology to address diabetic foot ulcers, obtained positive clinical results, FDA approval and favorable reimbursement rates, all of which subsequently increased sales from $9m in 2007 to $147m in 2010. The Company was recently sold for $750m to Ireland-based Shire plc.

The key is for managers to develop those same outside “fresh eyes.”

A Simple Exercise

Try a simple exercise. Put yourself into the shoes of an acquirer of your business and conduct some core “due diligence”.

1. What is the value proposition the business offers to the market? How well does your product offering meet customer needs – present and potential future needs?

2. Are they sustainable and what are the possible risks involved near and longer term?

3. What are your strategies for driving success in one, three and five years out? What is your ultimate objective and how are you going to get there? What will be required to profitably grow the business?

4. Does the company have the wherewithal, resources, talent and staying power to realize its goals?

5. How durable are your competitive advantages (e.g., intellectual property, core competencies, exclusive sales channels, long-term regulatory hurdles, other barriers to entry)?

6. To what extent are you driving innovation in your industry (both within your products and elsewhere)? What growth initiatives do you have in place (*e.g.*, R&D pipeline, new markets)? What is your long-term outlook for growth?

7. How intense is the competitive environment? Are you in a good competitive position or are you vulnerable?

8. What outside trends are impacting you or could be impacting you in the future (*e.g.*, economic, demographic, regulatory, governmental, new technology)? Are you vulnerable to such changes or are you in a position to take advantage of opportunities that may come from such changes?

9. How strong is your ability to adapt to changing circumstances?

10. Where are you susceptible to operational risk (e.g. – supply chain interruption, product safety/efficacy, pricing changes, low cost suppliers)?

Assessing the Business Value You Have Created

The answers to these fundamental questions will give you a sense of the business value you have created. Business value is based on both absolute and relative measures, both near-term and longer term. It is absolute in that it is a function of the operating cash flow you are generating. It is relative because business value is set by the marketplace and how you compare with competitors. Value is derived both from the results that you are achieving today and the potential you can predictably realize in the future.

Balancing Short and Long Term Perspectives

All managers have an idea of their near-term earnings outlook. Most managers tightly manage costs to improve near-term results. Potential buyers, however, take a hard look at the underlying dynamics influencing demand and driving growth and earnings. Managers build value by putting themselves in position to take advantage of those underlying drivers, risk-adjusted for uncertainty.

Often, the challenge of long-term positioning involves investing in new sales and marketing resources, new machinery and equipment, or more engineering talent. Making these investments may provide a platform for future growth but also entails a short-term earnings hit before the investments bear fruit -- and obviously there is the uncertainty that the objectives will be realized. There is a temptation to focus on near-term earnings and delay these investments, but seeing your company as a buyer may cause you to be more rigorous in your decision-making, measuring outcomes and adapting to changing circumstances.

Burst the Bubble

Often, an insular insider view of your company may distort the true value of a technology or product line. As the technology or product matures, large dollar, time and resource commitments to a given product may result in diminishing returns that do not justify the same levels of backing. Frequently, R&D is over-valued because of the riveted attention and sunk costs involved in developing a technology. Taking the view of a buyer of your business may allow you the freedom of looking at the business, product or technology more objectively and be open to acquire other technologies or align with other companies to strengthen the business. Even Fortune 500 companies are guilty of over-investing in a maturing, company-owned technology rather than seeking more promising technology that is "not invented here".

10 Steps to Build Fundamental Value

1. Conduct due diligence on yourself and create an informal offering memorandum to embody your analysis and see how you would look to outsiders.
2. Critically model and analyze the growth and profit potential of your business over the next 3-5 years, taking into account its maturity and stage in the life cycle spectrum.
3. If results fall short of your goals, consider new opportunities, innovation and other options that may be needed to reach your goals.
4. Assess the driving forces that will shape healthcare in general and your niche specifically over the next 5-10 years – being especially mindful of the potential risks and opportunities involved.
5. Determine how to create true differentiation and competitive advantages that will increase the probability of success and enhance value relative to competitors.
6. Develop a deeper understanding of your customers' needs – both today's needs and emerging needs – and accelerate efforts to satisfy those needs and turn them into revenue.
7. Reduce your operational risks such as dependencies on singular products, people, vendors and customers.
8. Evaluate the competencies that your organization will need to create future success in your industry and put your key people in a position to develop those competencies and drive that success.
9. Transition from strategies and investments structured around a "forecasting and control" mode to those that take into account probabilities and differing potential outcomes, so that you are positioned to take advantage of changes in the healthcare environment.
10. Open up judicious dialog with other parties in adjacent spaces, obtain feedback on your initiatives and determine what partnerships may be needed for future success.

Innovation and Growth Potential

Profitable growth is fundamental to creating business value. However, it is easy for managers to be caught in the trap of "doing more better" as their primary source of growth. Eventually, product line extensions fail to achieve significant growth and there are no more new major geographic markets available for your current product offering. Innovation, both within your product line and in other areas, is the key to long-term growth. Despite the day-to-day demands of managing a business, it is critical for managers to step back and ask themselves how they can skillfully innovate and what investments they need to make today that will drive longer term productive growth.

Competitive Environment

Savvy buyers of companies know that the competitive environment has a major impact on value. This is because even an outstanding management team will be limited in what it can achieve in hotly contested markets. If you find yourself in such a situation, look for ways to expand your technology or your unique competencies into different markets or find niche markets that, when combined, can add significant business value. In fact, several profitable niche markets where the majors are less dominant can often provide the additional capital needed to stay competitive in more highly contested markets.

Environmental Forces and Trends

The medtech industry in the U.S. is undergoing tremendous change. The future winners will be the ones that take advantage of this change. This does not mean looking into a crystal ball; there is too much uncertainty to accurately predict these changes. The winners will be those that recognize the uncertainty and shifting dynamics and create adaptive strategies to better position themselves to take advantage of whatever the future may bring. It may also require strategies that are designed around "learning and experimenting" approaches rather than "forecasting and control" approaches. Times of great change involve great risk but also involve great potential for building business value.

Operational Risk

Anyone wanting to acquire your business will be examining all of the associated intrinsic and extrinsic risks – technology obsolescence, lowering reimbursements, marketing unapproved indications, unintentionally infringing a patent, etc. -- that could burn them later and reduce the value of the business. Management teams – with a degree of self-due diligence -- need to be looking at those same risks upfront because they have the potential to build in a future problem. While there is some debate as to whether you can or cannot predict "black swans," there is an increasingly clear understanding that risk management is becoming an important management discipline that is necessary for preserving business value.

Determining How to Build Value

While this exercise sounds straightforward, it is always a challenge to step out of your current paradigm. You may find it helpful to bring in a skilled expert to help you develop an informed outside viewpoint and package the business as if it were being presented for sale, even if there are no plans to do so.

This exercise will start to give you an idea of whether you may be investing too much in current assets and not enough in building new assets. There is always another perspective to consider. You may find that you need to put a more concerted effort into finding new areas of opportunity. You may also find that it would be prudent to divest some assets. You may even find that you need to reposition your business for long-term advantage.

At the heart of this is the quest for fundamental business value. At the very least, going through this exercise will help your management team focus on this important measure and make it a primary strategic objective. When properly utilized, it will provide clear insights into profitable pathways to future success.