

# MedTech STRATEGIST

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# Beware the Seductions of M&A

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*A leading medtech consultant points out some of the potential missteps that device executives may not consider when caught up in the excitement of the M&A path.*

Recently, I met with a client executive planning a major internal medtech growth initiative. The conversation was fascinating because, even though it was not at all about M&A, the seductions of M&A became vividly clear to me. It is not surprising that M&A has become such a frequent lever for senior executives in the healthcare industry.

The executive was outlining two obstacles to successfully implementing the initiative: 1) the internal politics surrounding which executive(s) and/or business unit(s) would be awarded the investment dollars to pursue the initiative, and 2) skepticism whether the company would have the necessary patience and perseverance to fund the initiative's drain on earnings per share through annual budget scrutiny over the next four years.

M&A options are seductive in comparison. Acquisitions, particularly in times of low interest rates, have virtually no P&L impact and usually come complete with management teams. You don't have to build them; you just buy them! As further fuel for M&A activity, medtech IPOs have become far less common so small companies are increasingly built with the goal of being acquired.

There are two main rationales for acquisitions: 1) increasing

the strength of an existing business, and/or 2) diversifying into a new higher growth business. Each of these suppositions needs to be thoroughly tested during commercial diligence efforts before placing what can prove to be bet-the-company gambles. Below, I will address each of these rationales separately.

## Elusive Economies of Scale in Supply Chain

The first rationale is usually supported by faith in the law of economies of scale, either in the supply chain or in sales and marketing. While supply chain economies are possible, they are more difficult to achieve in the medical device industry than many other industries. Economies in the supply chain costs of consolidating manufac-

turing and/or distribution functions can be elusive as healthcare customers—because of the fear of ever being out of stock—greatly value proximity of locations and dual sourcing; consolidating operations can lead to sales losses that dwarf the potential cost savings.

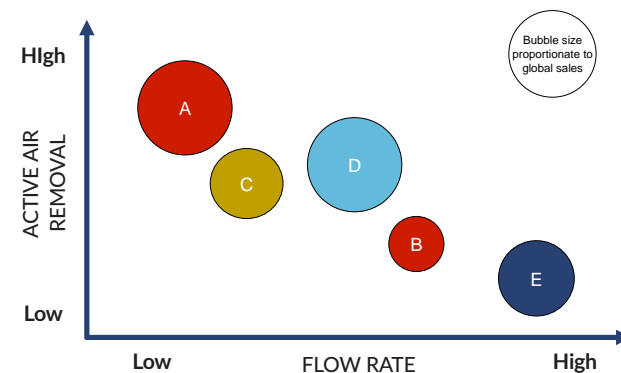
The common strategy of merging two competitors and consolidating product lines to the lowest-cost product line can suffer sales losses because most healthcare product markets are comprised of numerous subsegments due to a variety of clinical conditions and/or healthcare provider preferences. One needs to first map the key product characteristics of each product line vs. those of competitors' product lines to determine how easily customers can be switched to the

low-cost product line. *Figure 1* summarizes the predicament of a cardiopulmonary circuit client that had been formed through the merger of a company with product line A and a company with product line B. As you can see, in the free market, many customers had chosen products C and D. If the company were to only offer product A, its customers that had previously chosen B would prefer C or D to A. Likewise, if the client only offered product B, its customers that had previously chosen A would prefer C or D to B.

Figure 1

### Risks in Consolidating Product Lines

Example from recent merger involving cardiopulmonary technology



Source: Health Advances

## Elusive Economies of Scale in Sales & Marketing

Although megamergers like **Medtronic plc/Covidien** and **Becton Dickinson & Co./CareFusion/Bard** publicly aspire to capturing economies of scale in sales and marketing, in our experience, these economies prove tough to realize due to three main challenges:

1. difficulty raising most product decision making to the C-suite,
2. inherent subspecializations within the practice of medicine, and
3. individual salespeoples' limited bandwidths.

The first challenge confronts the reality that the vast majority of medical device decisions are made by individual health-care providers (e.g. physicians, nurse administrators, respiratory therapists) with an intimate understanding of their needs and product features. Despite numerous companies' attempts to gain the attention of healthcare facilities' C-suites and thereby elevate decision-making above time-consuming user-by-user detailing, the reality is that product purchasing is seldom a high priority for C-suites and companies are encouraged to meet with the decision makers lower in these organizations. The limited exceptions are companies providing products representing significant total spends in categories becoming commoditized; imaging equipment is a good example.

Healthcare practitioner titles can be misleading. We once had a client with seven divisions selling to "anesthesiologists" that requested a salesforce reorganization assuming that the organization could be greatly rationalized. We immediately ran into the two remaining challenges—practitioner subspecializations and salespeoples' bandwidths. There are several subspecialties within anesthesiology—anesthesiologists who focus on surgeries vs. deliveries vs. outpatient pain management with various local anesthesia techniques. In addition,

CRNAs often perform anesthesia and are inclined to choose different products than anesthesiologists. We determined the client needed at least three different salesforces to adequately address its target end users.

Then, as we considered the optimal size of the salespeoples' "bags," from our work across the industry, we know that sales reps often attain the same total sales volumes regardless of whether they represent three, four, five, or six product lines! When given too many product lines, individual reps focus on the subset of product lines where they have the greatest knowledge and where they can earn the easiest commissions. To maximize sales cost-effectively, we recommended the client establish a total of four salesforces in order to field two salesforces focusing on overlapping subspecialists.

## Too Much Diversification Through Acquisitions


As the inherent growth of many health-care markets slows, companies are increasingly acquiring businesses with greater growth prospects in new market segments. There are two largely unappreciated traps to this logic. The first is that if economies of scale are unattainable for any of the reasons listed above, it may be difficult to pay the acquisition premium required to consummate the deal.

The second trap is that the diversification may make the combined company less attractive to its future potential acquirers! And this comes with a cost that is never quantified. Even if a management team or board is eager to maintain a company's independence, in today's active M&A environment, company valuations are driven partly by the likelihood of an acquisition with a control premium. A company known to be of little interest to strategic acquirers will therefore trade at a lower valuation. Helping many executives compile their M&A "shopping lists," we have seen lots of seemingly brilliant diversifying acquisitions inadvertently reduce their owners' attractiveness as acquisitions. Examples include:

- A women's diagnostic company that acquired a small therapeutic device to become a women's health company: our client, a major diagnostic company with no appetite for potential medical liability, was no longer interested in this company.
- A cardiovascular single-use device company that acquired a technology requiring capital equipment: our client, a company with no interest in the servicing or financing requirements of capital equipment, was no longer interested in this company.
- A monitoring company that acquired a physician preference product line: our client, a company that thrived on conversions of departments eager to standardize on equipment, was no longer interested in this company now requiring intense salesforce detailing.

## Summary

To be clear, we are not against M&A. We believe the right acquisitions can quickly redefine competitive dynamics and/or accelerate new growth trajectories. In fact, our firm has recommended over \$100 billion of M&A transactions during our 26-year history and our clients are pleased with the vast majority of the outcomes.

However, in the current M&A fervor, we are eager to highlight the seductive nature of acquisitions so that senior executives will more carefully consider and pressure test their underlying assumptions about the availability of various economies of scale and the advisability of certain diversifying directions. 

*Mark Speers (Mspeers@healthadvances.com) is Co-Founder and Managing Director of Health Advances LLC. Its 150 professionals support senior executives with their most critical decisions including the global commercialization of new technologies and evaluating M&A options.*