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M&A ANALYSIS

Converging Trends Drive Industry Consolidation

Device industry M&A activity hit both volume and value highs this year as the industry continues to be in a strong seller's market. Here's a look at some of the transactions that took place in 2006.

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Medical device industry merger and acquisition activity has remained at a high level over the past year, despite an increasingly challenging operating environment. Adding to the challenges are pricing pressures in many device categories, increased regulatory scrutiny and issuance of warning letters to several prominent companies, and uncertainty over the effect of CMS inpatient reimbursement proposals. Nevertheless, industry continues to be in a strong seller's market. Valuations are at high levels for companies with leading market positions, proprietary products and technology, valuation intellectual property, and visible long-term growth and profit potential.



For the first nine months of 2006, there were 116 medical device transactions, compared with 115 for the same period last year. Excluding the monster Boston Scientific/Guidant transaction, the aggregate acquisitions price dollar volume was \$11.7 billion, compared with \$10 billion in 2005. [Table I](#) lists a sampling of transactions. Merger and acquisition activity is anticipated to continue at a brisk level for the foreseeable future as the industry continues to consolidate.

One of the key dynamic factors driving industry's trend toward consolidation is the large universe of small and medium-sized companies. These firms often do not have the financial resources to complete the development of promising products and deal with complex reimbursement issues. In addition, they struggle to perform the necessary clinical trials and to establish the necessary distribution channels. Being acquired by a larger company that can satisfy these needs is a viable alternative for the owners of many smaller companies.

Both strategic corporate acquirers and financial buyers, such as private equity firms, are attracted to industries with high growth potential. The medical device industry fits the bill as such an industry because of a basic demographic factor. The rapidly growing number of elderly in the United States will drive the demand for medical device products of all types. The Census Bureau estimates that there will be 54 million people over age 65 by 2050, compared with an estimated 35 million in 2000.

Acquisition Strategies

The largest transaction in 2006 was the acquisition of Guidant Corp. by Boston Scientific Corp. in April for \$25 billion (7× revenues, 32× earnings before interest, taxes, depreciation, and amortization [EBITDA], and 60× net income). Now with a cash hoard of more than \$15 billion and extensive annual free cash flow, it's conceivable that Johnson & Johnson is chomping at the bit for a blockbuster acquisition. There are not many potential candidates like Guidant, however, and J&J may have to be content with several smaller transactions. In February, J&J acquired Animas, a producer of insulin delivery pumps, for \$518 million. And in May, its Ethicon unit acquired Vascular Control Systems, a privately held company focused on developing medical devices to treat fibroids and to control bleeding in certain obstetric and gynecologic applications.

The reality is that with the stent business slowing and with a rather weak pipeline of new pharmaceutical products, J&J

must make acquisitions to achieve its objective of double-digit revenue and earnings growth in the long term. In addition, many large pharmaceutical companies face the same challenges, particularly as some of their major drug products lose patent protection in the next four years. They will continue to target small and medium-sized medical device companies to satisfy their needs, and this will be one of the major driving forces of a very active acquisition environment.

The convergence of pharmaceutical/ biotech products and medical devices is a developing trend that will continue to affect industry's M&A climate. J&J started the trend when it acquired Scios. Scios provided the drug used by J&J's Cordis Corp. when it introduced Cypher, the first drug-eluting stent, in April 2003.

In 2005, both Merck and Bristol-Myers Squibb publicly stated that they had an interest in exploring medical device acquisitions. Recently, Merck made an interesting move when it announced that it would acquire, for \$95 million, an 11% interest in FoxHollow Technologies. The acquisition is in conjunction with an exclusive research collaboration agreement under which Merck will provide a minimum of \$60 million in funding. FoxHollow, which has some innovative cardiovascular disease treatment products, went public in 2004.

Actually, this pharma and medical device convergence is not a new trend. Rather, it is the reemergence of an old trend. Back in the early 1990s, pharmaceutical companies acquired medical device companies with mixed results, and many of the device companies were subsequently divested.

The recent acquisition moves of Angiotech Pharmaceuticals Inc., producer of the drug product for Boston Scientific's Taxus drug-eluting stent, is a good example of this trend. In its public announcements, Angiotech bills itself as a pharmaceutical and medical device company. In early 2006, Angiotech acquired American Medical Instrument Co. The purchase price was \$785 million in cash—4.5× revenues of \$174 million. Angiotech further enhanced its medical device activities with the July acquisition of Quill Medical, producer of Contour Threads, an innovative suture product used in minimally invasive cosmetic and other surgeries. The purchase price was \$40 million in cash plus future milestone payments based on meeting certain revenue levels. That sort of payment structure is common in medical device acquisitions. This transaction also shows how a collaborative agreement between two companies often leads to an acquisition transaction. In 2004, Angiotech and Quill entered into an exclusive manufacturing and distribution agreement for the Contour Threads product line.

Private Equity Funds

Another trend that favors the owners of device firms positioning their companies for an acquisition transaction is the strong interest of private equity funds. Such funds often make add-on acquisitions to their current device portfolio companies and acquire firms to establish a platform in the industry. More than 50 private equity funds are actively seeking acquisitions. Their interests cover the broad spectrum of device-related companies. These include OEMs; suppliers of components such as valves, sealants, pumps, and materials; and contract manufacturers. Private equity funds currently have huge amounts of capital that they wish to invest. For example, in just the first nine months of 2006, they raised \$172.2 billion, compared with \$109 billion raised in the same period in 2005.

The largest medical device private equity transaction announced in 2006 was the proposed acquisition of publicly held Encore Medical Corp. by Blackstone Group, one of the largest private equity funds with capital of \$28 billion. The purchase price is about \$787 million, a 35% premium over the price of Encore's common stock before the transaction was announced. It represents a multiple of 2.7× revenues of \$300 million, and about 18× EBIT. Encore manufactures a broad range of orthopedic devices, including surgical implants.

A smaller transaction by a private equity fund was the acquisition of BioLok International, a producer of a dental implant system, by HealthPoint Capital for \$33 million (4.8× revenues of \$7.2 million). As with many small medical device companies, BioLok had a developed product but lacked the capital to enhance its sales and marketing efforts in the United States and abroad. With the financial backing of HealthPoint, it should now be able to do so.

In 2006, several private equity funds successfully sold medical device companies acquired in previous years. Presumably, they will deploy some of the proceeds into new acquisitions. One of the largest transactions was the acquisition of Suros Surgical Systems Inc. by Hologic Inc. for approximately \$240 million (8.8× revenues in 2005 of \$27 million) plus additional payments over two years if certain performance criteria are met. Hologic is a publicly held manufacturer of

medical imaging systems, and Suros produces minimally invasive surgical technologies focused on biopsy. Hologic had been seeking acquisitions to broaden its product and service mix in the women's healthcare area, and Suros was an excellent fit. The private equity and venture capital firms that sold Suros were Morgan Stanley Venture Partners, Rose Hulman Ventures, River Cities Capital, Sightline Partners, Periculum Capital, and Twilight Ventures.

Another example of a successful sale of a medical device company by private equity firms is the pending acquisition by U.S. Surgical (a Tyco Healthcare subsidiary) of Confluent Surgical for an estimated \$245 million in cash. Among the 13 sellers were GE Capital, Cross Atlantic Capital Partners, and CSFB Private Equity.

Specific Sector Activity

The U.S. Justice Department's announced probe into pricing policies in the high-growth orthopedic area in June did not extinguish or dampen acquisition activity. In addition to the Encore transaction, there were several other transactions and there continue to be others in process. Stryker Corp. acquired Sightline Technologies Ltd., an Israeli endoscopy equipment company. Revenues were not disclosed. The purchase price was reported to be \$50 million in cash, plus a potential \$90 million more in Stryker common stock in 2007 if Sightline achieves certain operational and financial targets.

Another orthopedic transaction structured with a substantial contingent earn-out component was Integra LifeSciences' acquisition of Kinetikos Medical Inc. for \$40 million cash. The deal includes a potential \$20 million more based on meeting certain future performance targets. The purchase price was 3.5× Kinetikos's revenue of \$11.4 million. Kinetikos is expected to strengthen Integra's presence in the orthopedic hand market and should help Integra leverage its regenerative products for dermal tendon and nerve repair. The combination of Integra's portfolio of collagen-tissue-engineered products and Kinetikos's upper-extremity implants should create significant marketing synergies.

The cardiovascular and catheter component segment of the industry also had some significant acquisition activity in 2006, and more is expected in the future. Catheter-based technologies for the treatment of vascular and other diseases has become a high-growth market. Many companies developing such technologies would improve their chances of realizing their potential if they were acquired by or developed a partnership with a financially strong company.

The acquisition by Terumo Corp., a Japanese company, of MicroVention Inc., a producer of catheter products for endovascular treatments, is a good example of a win-win situation for both buyer and seller. Terumo will give MicroVention access to Japanese markets and capital resources for further product development. In exchange, Terumo will have innovative catheter products to add to its s of products.

Another transaction in the catheter area was C. R. Bard's acquisition of Venetec International Inc. for \$166 million in cash. The sellers were 10 private equity and venture capital firms. Venetec's catheter products, including its innovative, highly regarded Statlock devices, will complement C. R. Bard's product mix. C. R. Bard will also get Venetec's extensive intellectual property portfolio, including 245 patents and patent applications.

The owners of medical device component companies, many of which also sell their products to other industries, should continue to have the opportunity to explore the sale of their companies at attractive valuations. A large number of U.S. and foreign potential buyers, both strategic and private equity, are aggressively on the prowl for acquisitions.

What Buyers Want

Buyers are usually particularly interested in companies with patented or proprietary products or techniques. The size of a company is typically not an issue. Buyers will look at companies as small as \$5 million in sales, particularly if the company is a nice add-on to one of their existing operations. When Controlotron Corp., a producer of advanced lines of ultrasonic flowmeters, was looking for a buyer, HT Capital identified more than 50 potential acquirers. In 2006, Siemens Corp. was the ultimate acquirer after an intensive competitive acquisition process. Another excellent example in the component area was the acquisition of Curlin Medical by Moog Inc., a publicly held manufacturer of precision control components and systems sold to the medical and other industries. In 2005, Curlin's revenues were \$16 million and its EBIT was \$5.4 million. The purchase price was \$75 million (4.7× revenue and 13.9× EBIT).

A private equity–sponsored transaction was the acquisition by MicroGroup Inc. of Bolt Bethel LLC, a manufacturer of precision metal components sold to the device industry. MicroGroup is a portfolio company of Kirtland Capital Partners, a private equity firm.

An alternative to outright sale for the owners of both privately owned and publicly held device firms is to sell a minority ownership interest. This can be done in connection with an exclusive or nonexclusive agreement to share technology or distribution channels, or to collaborate on the development of a new product. Often such arrangements lead to an outright sale of the business in the future at a valuation not achievable at an earlier date. A good illustration of this transaction scenario is Becton Dickinson's September agreement to acquire TriPath Imaging, which develops and manufactures products for cancer detection, diagnosis, and treatment selection. BD had already owned 6.5% of TriPath, and the companies had been collaborating in the area of cancer diagnostics. BD had publicly stated that it wanted to enhance its activity in the cancer diagnostics market. The purchase price of \$355 million represents a whopping 80.7% premium over the closing price of TriPath's common stock the day before the transaction was announced— approximately 3.9× revenues, and 53× TriPath's EBIT.



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Conclusion

Although there is no crystal ball, no eliminations or drastic changes in the fundamental trends and forces driving the high level of device M&A transactions are anticipated. The specific transaction examples discussed give a clear indication that there are many creative ways to structure transactions to meet specific owner and company objectives. The window of opportunity should remain open for medical device company owners wishing to explore the sale or partial sale of their businesses. Such a sale may be the way to achieve personal liquidity while also gaining the financial and other resources required to realize the growth potential of a company.

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Deal Size (\$M)	Buyer	Unit Sold	Date Closed
25,227.95	Boston Scientific Corp.	Guidant Corp.	24-Apr
4,100.00	Abbott Laboratories	Vascular intervention and endovascular business, sold by Boston Scientific Corp.	21-Apr
1,977.06	Danaher Corp.	Sybron Dental Specialties	19-May
1,660.00	Siemens AG-REG	Diagnostic Products Corp.	28-Jul
1,236.72	Montagu Private Equity	BNS Medical GmbH & Co.	24-Feb
785	Angiotech Pharmaceuticals Inc.	American Medical Instrument Co.	23-Mar
678.12	American Medical Systems Holdings	Laserscope	26-Jul
636.37	Philips Electronics NV	Lifeline Systems Inc.	23-Mar
518	Johnson & Johnson	Animas Corp.	21-Feb
463	Coloplast-B	Urology, clinical, and consumer healthcare business, sold by Mentor Corp.	2-Jun
383.02	General Electric Co.	Biacore International AB	7-Sep
333	Orthofix International NV	Blackstone Medical Inc.	10-Aug
290	Dj Orthopedics Inc.	Aircast Inc., sold by Tailwind Capital Partners	7-Apr
240	Hologic Inc.	Suros Surgical Systems Inc.	31-Jul
200	Terumo Corp.	MicroVenton Inc.	29-Mar
166	C. R. Bard Inc.	Venetec International Inc.	10-Apr
165	Philips Electronics NV	Witt Biomedical Corp.	27-Apr
130.16	EV3 Inc.	Micro Therapeutics Inc.	9-Jan
117.09	Amplifon SPA	Ultravox Holdings Ltd.	30-Jun
101.97	Encore Medical Corp.	Compex Technologies Inc.	27-Feb
80	Integra LifeSciences Holdings Corp.	Radionics division, sold by Tyco International Ltd.	5-Mar
75	Moog Inc.	Curlin Medical LLC	11-Apr
50.08	Vision Systems Ltd.	Immunovision Technologies Inc.	2-Jun
50	American Medical Systems Holdings	Implantable electrical stimulation platform technology, sold by BioControl Medical Ltd.	26-Apr
50	St. Jude Medical Inc.	Savacor Inc.	3-Jan
50	Stryker Corp.	Sightline Technologies Ltd.	20-Mar
48.48	Natus Medical Inc.	Bio-Logic Systems Corp.	5-Jan
40	Angiotech Pharmaceuticals Inc.	Quill Medical	28-Jun
40	Integra LifeSciences Holdings Corp.	Kinetikos Medical Inc.	2-Aug
26.19	ATS Medical Inc.	3F Therapeutics Inc.	1-Aug
24.3	Viasys Healthcare Inc.	Tiara Medical	12-Jul
8	Kensey Nash Corp.	Intraluminal Therapeutics Inc.	26-May

Table I A sampling of key mergers and acquisitions in the medical device industry in 2006. Mergers are ranked by deal size (\$ millions). Source: Bloomberg and HT Capital.