Livingstone

Examining the Medtech M&A Boom:

Global forces operating on the sector

Livingstone curated a panel of CEOs, medical device manufacturers (OEMs), and private equity investors to discuss key drivers of the medtech M&A boom. We explored why medtech assets are trading at premium prices, asked how consolidation in the global medtech industry is impacting companies throughout the supply chain, and discussed what the future holds for medtech industry participants.

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GTCR

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CEO
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TOPICS

TOPIC I | MEDTECH INDUSTRY CONSOLIDATION

KARL FREIMUTH:
There has been significant merger and consolidation activity in the global medical device supply chain over the last decade.

OEMs: Abbott – St. Jude Medical. Zimmer – Biomet. J&J – Depuy Synthes. Becton – Carefusion & Bard. Medtronic – Covidien and recently Mazor Robotics. Smith's Medical division announcing a planned divestiture from Smiths Group.

Contract manufacturing organizations (CMOs): Orchid – Nordic Capital. Avalign – Linden. Paragon – NN. Integer Advanced Surgical & Orthopedic – Viant. Micro Group – TE. Cadence – Kohlberg. Resonetics – GTCR. Spectrum – AEA. Tecomet – Charlesbank.

What impact is M&A consolidation activity having on the medtech supply chain?

HUNTER CRAIG
We often see FTC-driven divestitures create some interesting acquisition opportunities in the proprietary device space. If you're a larger CMO player of scale, it also represents an opportunity because OEMs are trying to consolidate their supplier base. If you're a smaller supplier on a longer tail, and you know you're less specialized or qualified, it's a real risk.

CHRIS WITHAM
It has really created an opportunity for Motion Dynamics as what I would call a tier 2 or tier 3 supplier. The end customer might view some of these roll ups as competitors and so they don't want to source any new programs with them. It has created an opportunity for us to actually bid on more work, so consolidation has worked out well for us.

KEVIN CORDERO
Our company has smaller "speedboat" Divisions in the $100 million range and large billion dollar Divisions. Consolidation can actually be advantageous because some competitors in our smaller markets are getting acquired and becoming more centralized within the new/larger organizations. This results in less focus on their customer bases while we're staying decentralized and focused on our core markets.

STEVE SUNDBERG
Consolidation at the OEM level has provided opportunities for us. We are fortunate enough to be considered a strategic, or key supplier by some of the players initiating the acquisition. I can think of two cases where this opened the door for us to begin serving the acquired firm where we previously weren't doing so.

The consolidation trend has also developed several new non-traditional diversified industrial entrants who are building out significant medical device platforms or contract manufacturing organizations.

Some of those organizations include NN Corporation, Molex, Interplex, Nordson, and Freudenberg. Are these non-traditional diversified industrial players who are trying to get into higher growth markets making material inroads in the medtech space?

HUNTER CRAIG

Industrial companies have emerged as super aggressive acquirers in the space. They've crossed the bridge of getting comfortable with the medtech realm.

Compared to general industrial exposure, medical businesses have more stable growth, higher margins, and better returns on capital.

Industrial acquirers typically start small in the medtech space and then realize that relative to the rest of their core business, they can execute the same playbook in terms of core capabilities and competencies but be indexed to the benefits of the medtech space.

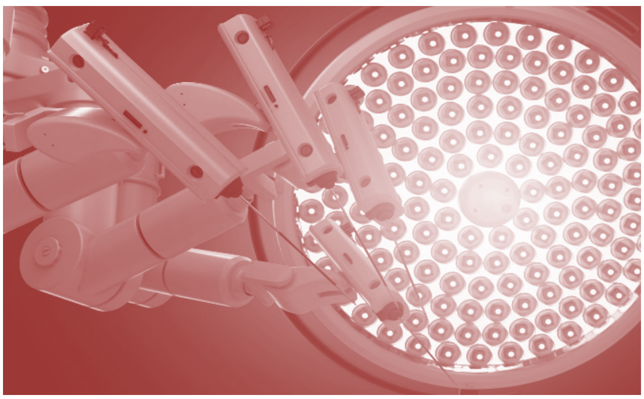
KEVIN CORDERO

Consolidation hasn't affected us much at all from this perspective. Hospital systems are looking to deal with larger vendors that have a broad product platform.

Fortunately, we're in a position where we do have that capability to work across divisions within the company to execute deals with customers based on implants and capital equipment and so forth.

So there are advantages to being tied to the scale of a larger manufacturing organization.

The customer tends to identify where our needs are in terms of looking to fill product portfolio gaps and adding different technologies to be able to better serve the hospitals.



What demands are medical device customers placing on contract manufacturers in terms of engineering support, design for manufacturability, customer acceptance rates, quality requirements, on-time delivery, etc?

CHRIS WITHAM
Consolidation hasn't affected us much at all from this perspective. Hospital systems are looking to deal This year we've done 34 validations relative to our first one five years ago. That all gets down to quality. It's a verification of the quality of product that you're going to provide to your customer. That's created a ton of work for Motion Dynamics because each customer has a unique requirement for validation.

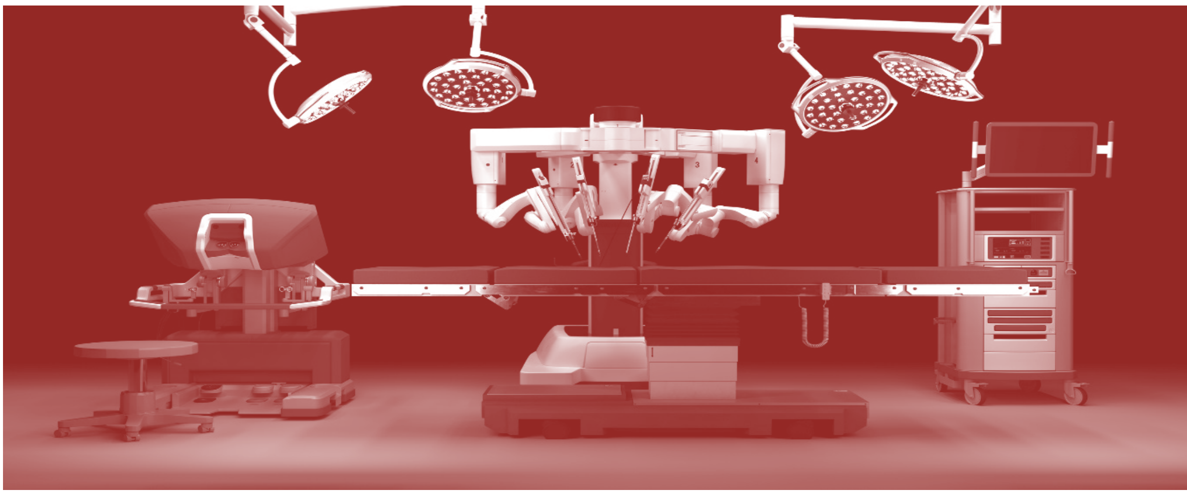
On-time delivery has probably been our number one focus this year. I compare things to automotive where the expectation is on-time every single delivery. A few years ago there was a lot more flexibility in delivery times and we didn't get held accountable if we missed. That has really changed.
We've made significant improvements in our business model where we're now north of 98 percent with on-time delivery where we used to play in the 60 percent range. And that's just not acceptable anymore.

Lastly, one of the biggest financial struggles we see is a push out of terms of payment. Typical for us two years ago was 30 days from the major OEMs. Now you're going to have to accept 90 days.

STEVE SUNDBERG
I agree with Chris in regards to the need to upgrade the talent in our quality organization. Five years ago, our Chicago location had one Quality Engineer along with our Inspectors. The Quality Engineer did everything from creating inspection plans to documentation control.

Today we have multiple Quality Engineers, multiple Document Control specialists and have increased the number of Inspectors we have. This has been driven not only by increased scrutiny the FDA is placing on Tier 2, and lower, suppliers, but also on the complexity of the products we are being asked to manufacture.

On-Time Delivery has always been an important metric. The larger OEM's have a definite cadence to their product launches, which makes it even more important today. You don't want to be the reason a launch of a new system is being delayed.



When you evaluate prototyping opportunities and next-generation platforms for the next chapter of growth for medtech CMOs, how important is it to be on the front end of prototyping those platforms such that you can't be displaced?

CHRIS WITHAM
That is literally our business model. We're very heavily weighted around engineering experience. Our entire business model is built on speed and being able to do things other businesses cannot do. The model is all about speed, and being able to get iterations to engineers very quickly so they can do multiple iterations of their design versus just one.

That is truly how we roll because once you get on a component assembly and it goes through the validation process through the FDA, unless you make a big mistake you're on there for the life of program. That's how we grow the business.

HUNTER CRAIG
We're able to be an efficient partner for medtech OEMs. We can help bring their products to market through clinical development. For regulatory reasons, CMOs end up being the sole supplier and spec'ed in on component products which is a nice place to be.

In addition, we have seen a greater number of people spin out from Medtech OEMs and start their own companies, which are great customers for CMOs. The public and private equity markets have been deploying capital to support those emerging companies and that dynamic is as robust today as it's probably ever been.

STEVE SUNDBERG
Until the last couple of years, OEMs were comfortable having their prototypes done at shops that specialized in quick turn-, small quantity protypes. Today, most will tell you they would prefer prototypes be done with the company that will bring it to production.

The challenge for us is having both business models operating under the same roof. We needed to adjust a lot of our standard process in order to strip out lead times and overhead. Prototypes don't need to have the same Quality procedures applied to them. We got it figured out, but it took a couple of iterations to get it right.

There's a significant proliferation of small to midsize medtech OEMs that could be potential customers for CMOs. How are CMOs taking advantage of consolidation activity at the OEM level?

HUNTER CRAIG

The medtech CMO space is probably one of the most fragmented markets we've come across. We work with multiple executives from Abbott who have communicated anecdotally that Abbott probably manages two to three hundred CMO companies across their supply chain, which creates an incredible amount of complexity. So you've got the organic growth tailwinds of underlying medtech volume growth and a narrowing of vendors to largest CMOs plus you have a robust follow on acquisition opportunity where you're in position to acquire and provide a broader set of services for the big OEMs. At the end of the day, that's kind of what they're trying to solve for here.

TOPIC II | RISKS FACING MEDTECH

KARL FREIMUTH:
Let's shift gears to talk through risk from each of your perspectives. The medtech industry continues to grow at a rapid pace with aging demographics, international competition, an evolving regulatory environment, and rapid technological development from a device and a component perspective. That introduces opportunity and risk in managing your respective businesses or investments.

How do you manage the key risks in your business?

CHRIS WITHAM
The thing that keeps me up most at night is a lack of available skilled labor. I would highly recommend if somebody doesn't want to attend college to learn a skilled trade. You will have a job forever. I truly believe that. Our company does very unique things. We don't have other competitors in the area that we can draw talent from. So we have to train every single person that walks in the door. I had a conversation with a gentleman last week who is running a robotics program and he talked about a 16-year-old kid who joined the program and he had never held a screwdriver in his life and that is a problem. That's a true story. So that's where we struggle is to find people who have a mechanical aptitude to be able to do what we need to have done from a technical standpoint.

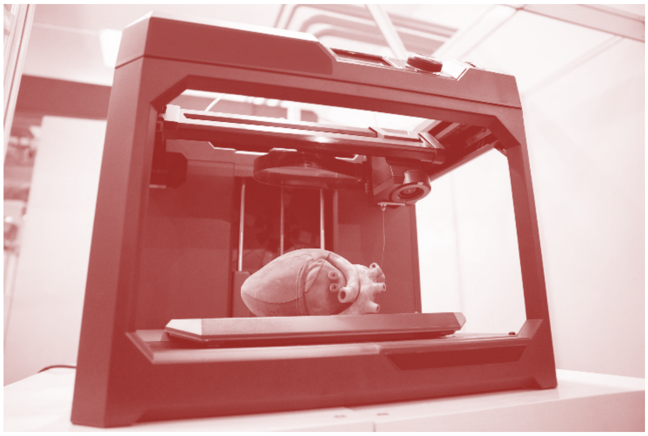
In addition, regulatory headwinds also represent a risk factor. Drastic changes in policy or the ability to get products to market based on uncertainty or variation like we're seeing in Europe –requiring additional verifications and validations which constantly changes our product development process.

STEVE SUNDBERG
I think the risk for a midsize CMO is not keeping up with regulatory and technological changes. If we get stuck in the trap of doing it lithe way we always have, we're dead. We've already talked about the need to increase numbers and upgrade the talent of our quality & regulatory organizations, but I see the same needing to be done in the engineering ranks, as well. In many cases, the OEMs do not have the talent in house to understand how best to manufacture their product.

Devices are becoming more complex. We are making instruments today with tolerances much tighter than we've ever seen. This requires us to have the technical talent on our side to better consult and guide the OEM in Design for Manufacturability, to create the strategies for manufacturing the product, and finally the skills to determine how best to inspect the product. We have transformed our company from being a job shop we built to print, into a medical device manufacturing firm that has the technical talent to interact with the customer as a valued partner in their commercialization strategy.

HUNTER CRAIG

The regulatory environment is only intensifying and that's something we are certainly evaluating at the board level. We are hiring incremental quality personnel across the Resonetics organization to keep up with the evolving regulatory environment. In addition, we are constantly evaluating customer product concentration. We're always trying to manage product concentration risk and make sure to avoid getting too beholden to any one customer or program.



Additive manufacturing tends to be a hot topic in the advanced manufacturing circles versus traditional subtractive manufacturing methods. How do you view additive manufacturing as a risk, and similarly as an opportunity for your business?

CHRIS WITHAM

With the type of process capabilities that we have, additive manufacturing is on my radar, but quite honestly, I don't view it as a risk. As far as 3D printing, it is actually a benefit for us from a tooling standpoint. It all comes down to customer satisfaction and customer satisfaction for us is driven by speed.

We can drive speed by some of the latest technologies out there where we can make a tool or a fixture on a printer versus going through our tool room.

KEVIN CORDERO

It is a very big focus and a big opportunity right now. The customer is looking for personalized medicine and patient-specific types of implants that we create now. But newer manufacturing processes can allow for newer innovations and efficiencies in both design and production. 3D printing has been talked about a lot.

I think there are going to be applications that are very well-suited for additive manufacturing and then there are certain areas that it really won't make inroads; in particular, surgical situations where the time to manufacture an implant doesn’t meet the urgent need for intervention or where the cost compared to alternative standard implants can’t be justified.

TOPIC III | MEDTECH GROWTH OPPORTUNITIES

KARL FREIMUTH:
Let's talk through market growth opportunities which from a sell-side perspective is a material driver of premium valuations in the medtech sector.

What is the next big thing from a technology perspective?

KEVIN CORDERO
Every year the Cleveland Clinic releases their list about where the medical device industry needs to go. Pain management with the opioid crisis right now is the top one on their list. Aneurysm repair and stroke treatment are large potential growth market categories. On the pharmaceutical side, immunotherapy. On drug delivery, nanotechnology.

On the device side, robotics and artificial intelligence, as well as patient-specific implants and virtual surgical planning, are hot topics for application and training purposes.

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How about growth opportunities outside of North America. Hunter, Resonetics recently completed an add-on acquisition in Israel, STI Laser. Kevin, Stryker is a global medical device organization. Chris, Motion Dynamics is supplying components to global OEM customers.

How do you view international market opportunities, be it in Europe with a different regulatory environment, or in China with a massive emerging middle-class population representing a significant future global growth opportunity?

HUNTER CRAIG
Chip Hance, CEO of Regatta Medical, is involved in GTCR's Resonetics investment. Chip was a 20+ year Abbott veteran and most recently built their vascular business. One of the first things he mentioned with Resonetics, which is based in North America, is what is the ex-U.S. strategy?

Since our investment, Resonetics has completed two add-on acquisitions, one in Switzerland and one in Israel. OEMs like to work with suppliers who have a global footprint and can be physically located in close proximity to where they are. By having an international/global operating presence, it just opens up the TAM (total addressable market) for the next buyer.

CHRIS WITHAM
In the last year at Motion Dynamics, we have sold to customers in 19 different countries. So we are truly a global business. Our biggest issue is finding qualified sales representatives. How do we turn over the rocks and find those opportunities across the globe? We have added a sales agency in China. We've added a sales agency in Europe and Israel, and then, of course, we're selling to customers across the United States. But there's a ton of opportunity on a global basis. It's just the challenge of finding those opportunities.

KEVIN CORDERO
Outside of the U.S. market, we've been incorporating more dedicated sales representatives by division or surgical specialty and moving away from more broad distributor models. So we have more direct customer interaction, focus and case coverage, in addition to specific marketing and regulatory teams dedicated to individual markets because the businesses are drastically different in Europe versus the U.S., as one example.

TOPIC IV | MARKET CONDITIONS & OUTLOOK

KARL FREIMUTH:
The final headline topic we'll discuss is drivers of capital inflows and M&A market conditions within the medtech sector. Its been white-hot over the last five years but really over the last decade, and as we discussed at the outset of the program, a ton of capital inflows and consolidation activity.

From the panelists perspective, what advice would you offer to a prospective business owner who's contemplating a potential sale?

What are some of the highly valued attributes for prospective acquisition targets?

HUNTER CRAIG
If I was advising someone selling their business, keep the story simple. Karl is going to ask you to write a 100-page deck. 15 pages is probably all that is required to tell the story. Keep the story simple, keep the numbers synthesized and straightforward.

Resonetics is a good example. We had a board meeting a couple of months ago and we're chatting with the team about the key operating KPIs for their business. Not 20 things but the three to five KPIs that you track to check the momentum of the business and longitudinal view of the operations.

These are the metrics that we track and help people draw lines into the future. And also keep the next chapter of the growth story as structured as possible.

Don't stray too much from what your business has historically achieved. I think that erodes credibility.

KEVIN CORDERO
Quality of operations, systems manufacturing, and making sure that the business is running the proper way. I mentioned a big risk earlier is the regulatory component. Seeing a medical technology that's been cleared by the FDA and has time on the market with feedback from the field is valuable. It helps us avoid unknown safety and efficacy issues with the product.

Ultimately, we want innovative products with growth potential. So products that are cutting edge that will help differentiate us versus commodity products, while also complementing our core portfolio, are attractive.

CHRIS WITHAM
The Vance Street group that I partnered with really liked our company as it was as it was really simple and really clean. Not a lot of excuses. We also weren't afraid to grow. We moved into a new facility that was specifically built three times the size of what we needed at the time as were prepared for growth. And that was four years ago. We're doubling the size of our facility right now. So I think those are the kind of stories that the people like to see – it's not the end of the runway.

On top of that, all buyers want to acquire companies with a diversified customer base. That is probably one of the most important things that you can do is have diversification.

STEVE SUNDBERG

My advice would be to spend time building and developing your leadership team. If you are playing in the Medical market, it is a given you have your Quality & Regulatory systems in place.

If not – make that job one.

But everything else we've talked about today involves being flexible and adaptable to the ever-increasing requirements of the marketplace. Doing this well takes top talent. People who embrace change, who are committed to growth, and who have high EQ's. Most of us can't afford large staffs with a person tasked with every job. So, we need to have a team of leaders who are comfortable moving from the Board room to the manufacturing floor, and back again.

A team that is committed to personal growth, as well as helping the organization grow. I'm confident that doing this increases the value to the enterprise, and for sure makes it whole lot more fun to be a part of.

For managers going through a sale process, what advice would you give to a manager given you recently went through a sale process?

What factors should they prepare for?

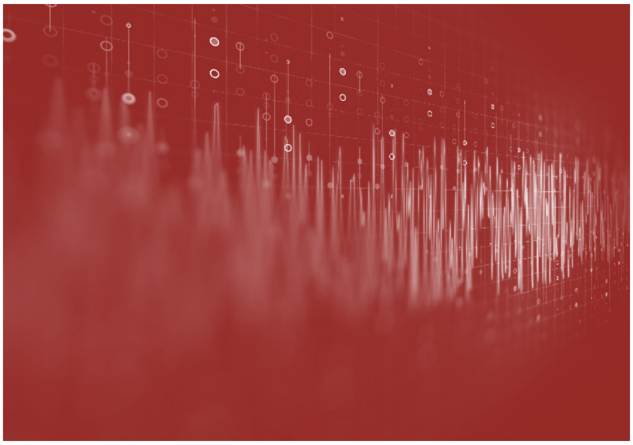
CHRIS WITHAM

Have patience. People are going to pull. It is like going through a physical 10 times over. They're going to want a lot of data, a lot of information, information that you might not view as important. But it is important to buyers. Just have patience.

For smaller or midsized contract manufacturing organizations, there is going to be fallout in light of all of the consolidation. It is an extremely fragmented market.

As Hunter alluded to earlier, Abbott is doing business with two to three hundred contract manufacturing organizations in their supply chain. OEMs continue to demand more from their suppliers.

Is there a window for smaller to mid-size medtech CMOs to exit in the near term or do they put their businesses at risk of losing business as their existing platforms sunset and new platforms are awarded to the larger CMOs with broader capabilities?



CHRIS WITHAM
It depends on what your capabilities are. One of my sayings is if you have a big moat around your business I think you're safe.

HUNTER CRAIG
If you are a smaller to midsize scale guy and you're not planning to invest a bunch of capital to grow your business organically or do acquisitions to get scale, I think you've got to seriously consider selling given where valuations are at and what the future might look like.

I think Karl's right. OEMs will continue to more aggressively consolidate their supply chains. And so if you're not going to sell, you need to get to scale pretty quickly.

Final question where rubber hits the road on value. It has been an incredibly robust market to sell medtech assets over the last few years.

Do you believe that valuations and multiples will increase, remain steady, or decline?

HUNTER CRAIG
I think multiples have peaked. We saw pretty rapid expansion over the last few years but we've kind of seen multiples settle out a bit. I think as much as it is about the multiples, buyer scrutiny of earnings and EBITDA underpins the ultimate purchase price. I think at least around our shop scrutiny of earnings is intensifying.

In the last 12 to 18 months, there has been like a whole new flavor of adjustments to earnings proposed by sellers. A lot of those proposed adjustments don't come to fruition. So I believe multiples are going to pull back and earnings will be presented on a more normalized, credible basis over the coming years.

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Karl is a partner and co-head of Livingstone's US Industrial practice, with particular transaction expertise in industrial technology, technical manufacturing, electrical equipment, medical device outsourced manufacturing, power generation, precision machining, capital equipment, and commercial & industrial services.

He has over 15 years of experience advising domestic and international mid-market companies on M&A transactions, debt and equity capital raises, and financial restructurings. Karl's clients and counterparties have comprised multinational publicly-held corporations, entrepreneur and family-owned companies, private equity firms, and family offices investors. His experience also includes advising on numerous cross-border transactions.

Prior to Livingstone, Karl was a Vice President in Mesirow Financial's Corporate Restructuring Group and a Senior Associate in KPMG's Corporate Recovery practice.

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