

Josh Copp  
Ruth De Backer  
Colin Field-Eaton  
Gerti Pellumbi

# Delivering growth: M&A in medical technology

Pharmaceutical and Medical Products December 2017

**M&A continues to be a core growth driver** for many medical-technology companies and will likely see increased activity as these players work to meet overall high-growth expectations for the sector. Yet this period is an era in which growth assets are scarce, so those that are available carry high valuations. Simultaneously, venture funding is slowing—and this combination makes executing traditional product-focused deals to sustain growth increasingly difficult for companies to execute. Against a background of industry headlines that seem to feature continued consolidation, what should medical-technology executives bear in mind when thinking about their own M&A programs?

We analyzed a broad set of medical-technology deals and performance data and found five key points for considering M&A in medical technology:

1. As growth becomes elusive, M&A becomes a must for scale players.
2. Industry consolidation is driving sizable bets with large deals by bigger cross-category medical-technology players, while more focused players execute smaller, more frequent deals.
3. Programmatic or selective M&A has produced excess total returns to shareholders (TRS), but execution will become harder due to scarcity of growth assets.
4. Large deals remain a high-risk but high-reward tactic.
5. M&A for “nontraditional” assets (for example, software or services) is rapidly accelerating in medical technology, as companies seek out new value pools to secure growth.

## Medical-technology companies at scale must do M&A

Looking at the 30 largest medical-technology companies by revenue, more than 60 percent of their 2011 to 2016 growth was due to M&A (net of divestitures<sup>1</sup>). These top companies use M&A as a way to stay on top: activity by these participants represented some 70 percent of the total deals in medical-technology M&A over that period.<sup>2</sup> We also analyzed 54 pure-play medical-technology companies that were publicly listed during a ten-year period (2006 to 2016) to evaluate their approaches to M&A (Exhibit 1). Only 20 percent of them relied on a mostly “organic” approach and used almost no M&A. Those companies that were active for the entire period and that took an organic approach were smaller—only 2 companies that grew organically reached \$2 billion or more in annual revenue by 2016.

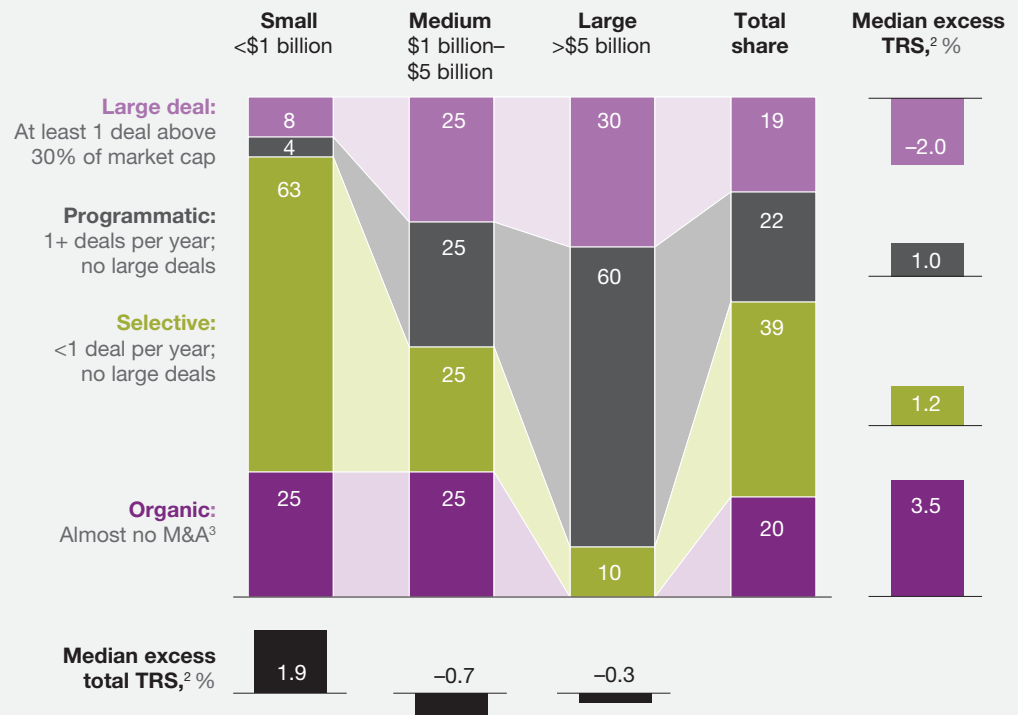
<sup>1</sup> One-time adjustment for sales lift of acquisitions with \$100 million plus target annual revenue or divestitures of \$100 million plus annual revenue. Reflects only publicly available data and does not account for future growth of acquired assets.

<sup>2</sup> Defined by the close date of a deal; includes all deals with a reported value where the target was in specific industry group for healthcare instrument and medical products.

## Exhibit 1

Selective, programmatic, and organic approaches have had positive excess returns.

Companies by deal approach and 2006 annual revenue,<sup>1</sup> % of total by company size (n = 54)



● ~90% of smaller companies pursue an organic or selective approach

● For larger companies, ~90% pursue a programmatic or large-deal approach—with programmatic generating more excess TRS on average

<sup>1</sup>Select medical-device companies that had data for entire 2006–16 period. Analysis based on 54 public pure plays with data over entire time horizon. Represents 24 small, 20 medium, and 10 large companies based on 2006 revenues.

<sup>2</sup>Total return to shareholders.

<sup>3</sup><0.5 deals per year and cumulative M&A spend of <2% market cap over entire time horizon.

McKinsey&Company | Source: Capital IQ; Dealogic; McKinsey analysis

### The type of M&A program medical-technology companies pursue is largely shaped by their size

For the 54 pure-play medical-technology companies described previously, 24 had annual revenue of \$1 billion or less in 2006. For these smaller companies, nearly 90 percent pursued an organic growth plan or selective approach to M&A for 2006 to 2016. For the ten companies exceeding \$5 billion in annual revenue, 90 percent pursued a programmatic or large-deal approach. The more mature and larger the company, the more intensive the M&A program. We also found that medical-technology companies pursuing an M&A strategy of numerous smaller deals (with the number of deals proportionate to their size) tend to see excess TRS over the broader healthcare-equipment industry.

### **Programmatic and selective approaches to M&A have produced excess TRS, but execution of these approaches will need to adapt given growth-asset scarcity**

Historically, programmatic M&A focused on acquiring smaller, innovative product companies has created excess TRS. However, this approach will become more challenging as innovative assets become scarcer and venture funding has slowed for product-focused medical technology. This scarcity of potential targets may lead to further consolidation and large deals as medical-technology companies pursue growth.

### **Additionally, large deals in medical technology remain a high-risk, potentially high-reward tactic**

Companies that have pursued large deals over the past decade have generally found creating value challenging, with approximately 2 percent lower average annual TRS versus the broader healthcare-equipment market. Further, performance for large-deal approaches lags the overall medical-technology index following an acquisition, averaging some 7 percent lower annual TRS than the market in the two-year period after the deal.<sup>3</sup> This scope stands in marked contrast to the short-term shareholder reaction<sup>4</sup> for these deals, which has generally been neutral to positive (averaging about 1 percent excess TRS). These results demonstrate the challenges of executing, integrating, and capturing expected synergies for large deals in medical technology. Specifically, shorter product life cycles with a risk of earlier obsolescence, fragmentation, and specialization of call points, together with specialized requirements for R&D and clinical development of new medical technologies, combine to introduce challenges to generating synergies from large deals.

### **Medical technology as a category is increasingly buying into new value pools to expand offerings beyond traditional products and tap into new sources of innovation**

Service and software deals represent approximately 15 percent of medical-technology deals from 2013 to 2017 (year to date), up more than 20 percent over the previous five-year period, 2008 to 2012 (Exhibit 2). This increase has largely been driven by a higher number of service or digital technology deals, which are up some 45 percent: for example, Cochlear–Sycle, Medtronic Diabetes, and ResMed–Brightree. As we’ve recently described,<sup>5</sup> these software and digital plays take a variety of forms—everything from acquiring cybersecurity expertise to improve networked device security to acquiring digital inventory-management tools to raise inventory efficiency. While still modest in volume as the industry continues to experiment, these types of transactions are likely to become even more important, as assets with innovative products become scarcer and business models are shaped by evolving revenue streams from data services, digital offerings, and advanced analytics.

Deals of this nature require a fundamentally different set of assumptions and skill sets across the spectrum of M&A activities from target sourcing to integration. For instance, if acquiring an advanced-analytics asset, how can businesses ensure the R&D organization is anticipating technical integration for a next-generation device? Acquiring the necessary skill sets is a

<sup>3</sup> Reflects two years from one month before announcement, to remove effect of announcement on acquirer’s share price.

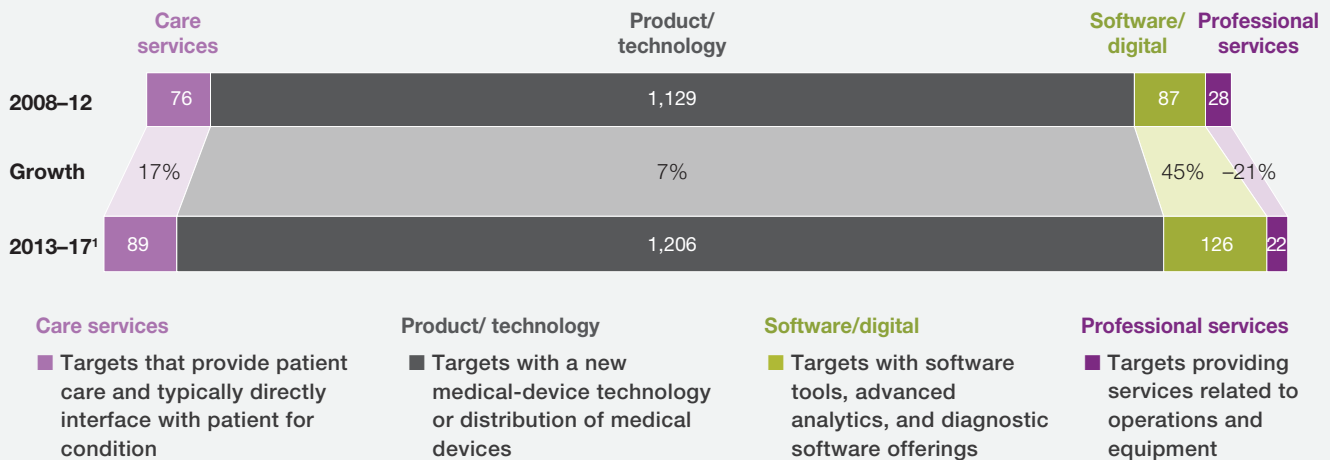
<sup>4</sup> Total returns to shareholders in excess of S&P 500 from two days before to two days after a deal announcement.

<sup>5</sup> See Siddhartha Chadha, Sastry Chilukuri, and Steve Van Kuiken, “How medical-device CEOs can navigate digital disruption in healthcare,” October 2017, McKinsey.com.

## Exhibit 2

Medical-technology companies expanded deal activity in software and services, with a 20-plus-percent increase for the 2013–17 period.

M&A activity by target business category, deal count



<sup>1</sup>Year to date for deals completed as of Oct 24, 2017.

McKinsey&Company | Source: Dealogic; McKinsey analysis

challenge many traditional medical-technology companies have faced when entering new businesses in software and services: for example, effectively integrating a new asset into traditional medical-technology functions, such as R&D or quality, setting up the right funding mechanism to sustain innovation, or establishing a commercial model that drives adoptions of the software or services. In relation to this synthesis, it is also worth noting that M&A is not the only way to access these nontraditional areas—we have seen a rise in partnerships between medical technology and other participants, which is starting to blur competitive lines. Whether the newest tie-up for Google or IBM, or new innovative collaborations between medical-technology companies and hospital systems, alternative deal structures to traditional M&A are also on the rise. As deals increase in size and scale, their impact on value creation will become greater and will require careful diligence and integration planning to ensure value is realized.

M&A remains a core tool for medical-technology companies to accelerate their growth expectations and create shareholder value. Successfully executing M&A—particularly in the context of a shifting mix toward new offerings beyond traditional devices—will require both careful execution of conventional deals and rethinking the your business development team’s capabilities as well as ensuring they have the tools to source, evaluate, and integrate deals of all shapes and sizes. How well is your M&A program positioned to deliver on your growth aspirations? □

**Josh Copp** is an associate partner in McKinsey’s San Francisco office; **Colin Field-Eaton** is an associate partner in the Washington, DC, office, where **Gerti Pellumbi** is a partner; **Ruth de Backer** is a partner in the New York office.

The authors wish to thank Roerich Bansal for his contributions to this article.