

# Health-Care Industry Acquisitions

*A particularly attractive opportunity has developed in health-care industry, but some potential acquirers remain reluctant*

BY JOHN WILKERSON

There are well over 1,000 health-care companies in the United States. For each of the last two years there have been at least 30 company acquisitions. Competitors and colleagues agree that everyone wants them. Why? Because health care is a business for those who in troubled times wants no trouble! But even though it seems to be true that everyone wants them, it is sometimes hard to believe when you watch the way it's done.

174 I wonder how many of these firms you have heard of? Barnes Hind, Cutter Labs, Miles Labs, Rucker, Cardiac Pacemakers, Ivac, Extracorporeal, Technicare, Clinical Assays, Deseret Pharmaceutical, Endo, Parke Davis, Nuclear Medical Labs.

All have fulfilled somebody's urge to merge! These companies were acquired through skill, pressure, and/or serendipity. But there are countless others where the urge to merge existed but for any number of reasons the marriage ended short of the altar. In many cases, the acquirer had a poor understanding of what might motivate the entrepreneurs in the target company.

## Ongoing Debate

There is an ongoing hearts-and-mind debate within domestic and foreign firms wanting health-care acquisitions. First, there is the large U.S. company, with sales of more than \$500 million and management which wants to diversify or avoid acquisition through acquisition. Management's corporate heart tells it to acquire, and the managers feel their stock is an excellent acquisition tool. But their minds remind them that their P/E ratio isn't what it used to be and that if they use cash they'll hurt EPS growth because of the goodwill write-off. But they also know that if they don't acquire, their later entrance into dynamic health markets may be preempted by competition.

The second group of internal debaters consists of large international firms eyeing the U.S. market.

\*Vice President, Medical Supply Analyst, Smith, Barney, Harris, Upham & Co., Inc., New York, NY, paper presented at LES U.S.A. Eastern Region meeting, April 1979.

Their heart tells them to stay away because of the chauvinism of U.S. consumers and because few foreign firms have been successful at this game. But their minds tells them to buy now because of currency appreciation in Europe, and the fact that their country's accounting standards may not required depreciation of goodwill. They also know that they need the U.S. medical technology and the large U.S. market, and that more so than in the past U.S. buyers will take cash.

There are 140 foreign companies operating in the U.S. health-care market today. Frankly, I'm surprised there aren't more. My contention is that circumstances favor more foreign buying in the U.S. health-care market. But many foreigners apparently haven't learned how to effectively market here and they haven't gotten over some ill-founded fears. Burdened by these two factors, many a foreign firm is still standing on the sideline.

## Potential Growth

I'd like to take a few moments to describe the U.S. health-care market and to share my thoughts on potential growth in various sectors of it.

Worldwide health care expenditures are \$700 billion, but only 10-11% of this is for products in the free world (Table 1). My best guess is that in the next five or six years the pharmaceutical sector will grow about as fast as it has in the past few years — at 9-12% (Table 2). Medical supply growth will continue to be greater than drug growth (Table 2). U.S. growth may ease a bit in medical supplies, but I wouldn't be surprised if international growth became even more robust (Table 3). There are many reasons for my optimism about medical supply growth overseas but foremost is the fact that many countries substantially lag behind the United States in acceptance of medical technology.

I've included Tables 4, 5, and 6 to illustrate the many different medical market segments and their approximate dimensions. These numbers make it fairly obvious why growth-minded managements are looking for

Estimated Size of 1980 Worldwide Health-Care Market Billions

World Spending For Health Care Product Expenditures in the Free World	\$700
Pharmaceuticals	\$48
Medical Supplies	\$27
Total	\$75

Table 1

### Estimated Growth of Worldwide Health-Care Markets 1970-1985

	1970-80 (%)	1981-85 (%)
Pharmaceuticals	9-12	9-12
Medical Supplies	14-20	13-16

**Table 2**

### Trends in Worldwide Medical Supply Markets 1979-1985

	Future Growth
United States	Constant or Down 2%
International	Constant or Up 2%

**Table 3**

ways to capitalize on the healthy medical supply business and to enjoy rapid international growth. There are other reasons supporting interest in acquiring medical supply companies, among them:

- 1) Thirteen of 23 medical supply segments are growing at more than 10% per year.
- 2) Eight of 23 segments are growing at more than 15% per year.
- 3) Overseas hospital labor costs are escalating, causing sales of medical supplies to soar due to substitution of disposables for labor.
- 4) Drug technology is worldwide, but medical supply technology remains primarily domestic.
- 5) Medical supplies are less regulated than drugs.
- 6) Product development costs are lower in supplies than in drugs.
- 7) New supply products are created weekly.
- 8) There is a perceived lack of price controls.
- 9) Drug houses (those with vision) see supply and drug industries becoming one due to changes in the ways patients are managed.

But there are other, more "personal" reasons why domestic firms are looking at supply firms:

- 1) Drug houses are flush with cash, but not all supply firms are cash flow positive.
- 2) Several firms are unhappy with their own R&D productivity.
- 3) Patient management will eventually use complementary modes of therapy such as in electrical pain control and cardiovascular drugs. Specialized firms may feel they need to offer both therapies.
- 4) Some firms have been victims of the sales success of their lower profit products.

Also, various firms believe that acquisitions are good diversionary tactics to prevent being acquired; that there is a need to cut the profits of drug houses; that it is cheaper to buy than to create; and that it is better to spread the risk since most drug house profit stems from perhaps only one to five products.

### Foreign Firms

And then there are the foreign firms. Why are they acquiring? I think the conflict between their mind and their heart will be won by the mind and further acquisitions will occur. I base this on several observations:

- 1) The United States has the technology.
- 2) The U.S. market is the largest and this is neces-

### U.S. Medical Supplies Market Size Ranking\* \$6 Billion

Product	Market Size Rank
X Ray	1
Dental	2
Dressings	3
Linens	4
Lab Reagents	5
Intravenous Solutions	6
Catheters/Tubes	7
Syringes/Needles	8
Gases	9
Dialysis Supplies	10

\*omits miscellaneous categories

**Table 4**

### U.S. Medical Equipment Market Size Ranking\* \$3-4 Billion

Product	Rank
Imaging	1
Laboratory	2
Computers	3
Monitoring and Electronic Assist	4
Dental	5

\*Omits miscellaneous categories

**Table 5**

### U.S. Medical Device Market Size Ranking\* \$1-1.5 Billion

Product	Rank
Ophthalmology	1
Pacemakers	2
Orthopedic implants	3
Numerous other areas	4

\*Omits miscellaneous categories

**Table 6**

sary to spread medical R&D costs.

- 3) Foreign firms may not have the same antitrust problems as U.S. firms.
- 4) They don't need to write off goodwill and can therefore pay cash.
- 5) The 1978 tax reform act makes it more enticing for U.S. firms to take cash.
- 6) German and Japanese firms need distribution in the U.S.
- 7) Acquisition of a U.S. firm could buy sensitivity to customers in the U.S. market.
- 8) Foreign firms are patient and willing to take partial equity positions now and take the rest of the position in the 1980s and 1990s.

Unless domestic forms become increasingly alert to the advantages held by foreign firms they may lose their edge in acquisition activity, because:

- 1) 100% responsibility and less than 10% authority are sometimes given the individual in charge of acquisitions. Often this person has an excellent feel of the market but limited financial backup. Accordingly, financial impact analysis is done last rather than first.
- 2) Large firms make invalid assumptions that small firms can't afford liability insurance, or that the FDA scares these small firms, or that any acquisition must be done entirely on a friendly basis.
- 3) The small company often balks because it isn't impressed with stock from large firms. The big firms feel

they need to use stock, but some small firms prefer cash.

4) Entrepreneurs don't see domestic firms allowing them to run their own firm. In addition, where does a medical entrepreneur get promoted to in a large non-medical conglomerate?

5) Small firms are worried about disclosure. They don't want to announce they are negotiating because it demoralizes employees. But U.S. firms are paying high multiples and feel they have the right to know what is in product development. The best way around this last point is to let it be known on day one that you won't have any discussions unless the potential buyers agree to the reasonableness of your price zone. Having done this, disclose only public financial information and have letters of confidentiality signed on critical product areas. At least this may discourage imitations of your products (now in research) from later appearing on the market.

Foreign firms have fewer real hurdles to acquisition. U.S. firms may even welcome them as a partial acquirer. Usually, the foreign firms need the existing

management. But international firms, as I said up front, have been slow to take advantage of the opportunities. Some are afraid of or badly puzzled by the FDA. Others fear employee loss and apparently expect what Americans think is excessive employee loyalty. I believe these firms will do just as successful U.S. firms have done overseas. That is, hire and promote locally. This has proven successful for U.S. firms abroad, and I see no reason why it would not work in the United States.

In summary, a particularly attractive opportunity for acquisitions and licensing has developed in the health-care industry. U.S. firms desire them because small firms have always been the source of much of their new growth. Since P/E multiples have eroded, U.S. firms have a more challenging task to convince sellers. Buyers who realize this will accept the fact that they need to upgrade the acquisition activity in terms of top-level management time or they will have a high strike-out rate. A stronger sales effort is now needed by companies who only a few years ago had P/E multiples of 40x and could merge with partners of their choosing.