



SUCCESSFUL SELLERS SEEK TO MAXIMIZE ACQUIRER VALUE

Buyer perception of business risk is a key determinant of successful medtech M&A, yet many companies fail to appreciate a potential acquirer's perspective and how it perceives value. We outline the steps that leaders of earlier-stage companies can take to improve their understanding of what prospective acquirers truly want and thus increase the likelihood of a successful transaction.

► PETER MEYER AND ODED BEN-JOSEPH, OUTCOME CAPITAL

As a catalyst for economic growth and scientific transformation, M&A transactions play a central role in shaping the life sciences sector. As life sciences advisors and transaction professionals, we routinely assist boards and management teams in devising clear, well-informed strategic pathways toward value

creation. This role has allowed insight into misconceptions that often lead to unnecessary failure. We have noted a recurring tendency, especially with respect to middle-market transactions, of an almost paradoxical relationship between the perceived value of assets by sellers versus their eventual corporate acquirers.

The vast majority of medtech success stories come through an acquisition or a structured transaction with a strategic player. Yet many leaders fail to fully appreciate how their company is viewed by potential acquirers. In this article we explore the perspective of the would-be strategic acquirer and how savvy leaders of earlier-stage companies can use this understanding to improve the probability of a successful transaction:

- What does it mean to maximize value for the acquirer?
- Acquirer perception of risk from an analytical perspective.
- Acquirer perception of risk from an emotional perspective.
- Return on invested capital for risk mitigation.
- Creating a transparent path to liquidity for investors and a path to value for acquirer.

What Does It Mean to Maximize Value for the Acquirer?

The **Value** of a given enterprise from the perspective of a would-be acquirer can be described simply as:

Acquirer Value = (Benefit-Cost × (1 - Risk)), where

Benefit is the intended gain from new talent, technology, and/or products;

Cost is the total investment required to achieve the Benefit, not only the acquisition cost;

Risk is the likelihood of a negative outcome for the acquirer, including:

- Risk inherent in the transaction (e.g., likelihood of legal concerns preventing deal closing)
- Risk associated with achievement of the intended benefit (e.g., product development risk, commercial risk, loss of key talent).

Following this paradigm, there are several ways for the would-be acquirer to maximize **Value**:

- Seek acquisition targets that provide the greatest benefit: top-notch talent, strong platform technologies, or differentiated products that can grow the market opportunity, take market share, and/or turn a strong profit.
- Minimize the required investment through accurate valuation, aggressive price negotiation, and leveraging previous investments to avoid duplication.

- Identify and mitigate key risks most likely to impact overall value.

The **Benefit** to the potential acquirer is largely predetermined by decisions made early in the life of the seller, such as, “What customer needs should be addressed? What solutions will be used to address those customers’ needs? What talent is needed to deliver those solutions?” For the acquirer, this becomes a predominantly binary triage decision, that is, “Is the purported benefit sufficient to capture our attention and warrant further investigation?”

The acquirer will have more control over the **Cost** and, to a lesser extent, the **Risk**. First and foremost, the acquirer needs to understand the true costs to achieve the desired benefit. In many cases, these costs will go far beyond the purchase price of the assets to include follow-on investments in the product pipeline and commercial expansion. Invariably, sellers grossly underestimate the required buyer resources for commercial expansion and broad product adoption. The acquirer will need to apply dispassionate portfolio management to determine which follow-on investments should be pursued or discontinued, and to modify its perceptions of benefit accordingly.

Acquirer perception of **Risk** is more complex and may pose an underappreciated opportunity for the seller to create value for both parties.

Acquirer Perception of Risk From an Analytical Perspective

While every prospective deal has its unique set of underlying risks, the risks inherent in the transaction itself are largely similar across different deals and are broadly familiar to M&A professionals. These risks are mitigated through *prescreening prospective deals* for obvious concerns (e.g., insufficient liquidity to reach a transaction, incompetent management, suspicious business practices) and careful due diligence.

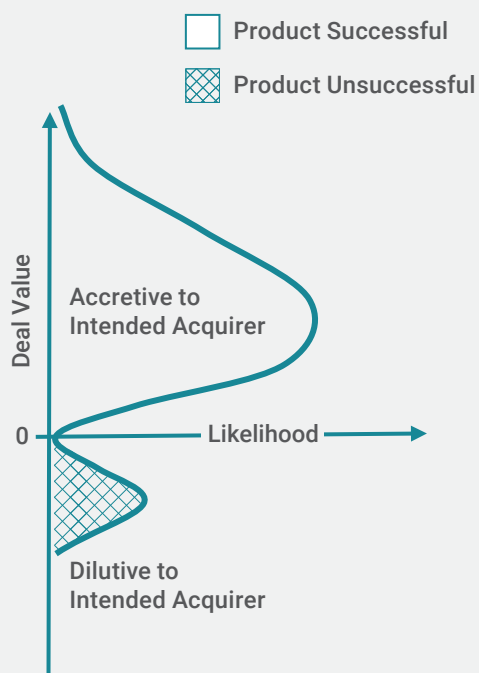
Each deal will also have a number of key risks specific to the business approach that could have outsized impact on the overall value of a transaction. For example, there may be elevated risk for a novel product solution in terms of *technology* development, *regulatory* clearance, and/or market adoption. Would-be acquirers also need to consider the risks associated with allowing a competitor to acquire the new talent/technology/product. *Figures 1 and 2* illustrate these risks in terms of the likelihood of various outcomes.

In the example depicted in *Figure 1*, the planned transaction exhibits a bimodal distribution of likely deal value due to a highly impactful binary risk (e.g., failure to achieve regulatory

clearance). The most likely outcome is a positive value, but significant risk remains of achieving a negative value (shaded area). Product risk can be binary (e.g., meets clinical endpoints or not) but in most cases is more related to time-to-market and rate of market adoption. Hence, viewing the transaction value as a distribution of potential outcomes may sometimes be more appropriate (see Sidebar, "Case Example: Consideration of Complex Acquisition Risk").

The would-be acquirer also needs to consider the potential impact of the target company being acquired by one of its competitors. The savvy acquisition target will work to create a competitive environment around its intended transaction, thereby improving its negotiation position and increasing the likelihood of closing a deal. Figure 2 demonstrates the nature of competition for a target company: the Intended Acquirer achieves a positive outcome if they close a good transaction (e.g., successful product) or if they reject the transaction and their competitor purchases an ultimately unsuccessful product.

Figure 1
Risks Impact Overall Transaction Value



Note: Expected value of a transaction demonstrating a bimodal distribution. The most likely outcome is a positive value, but the shaded area indicates the risk of achieving negative value.

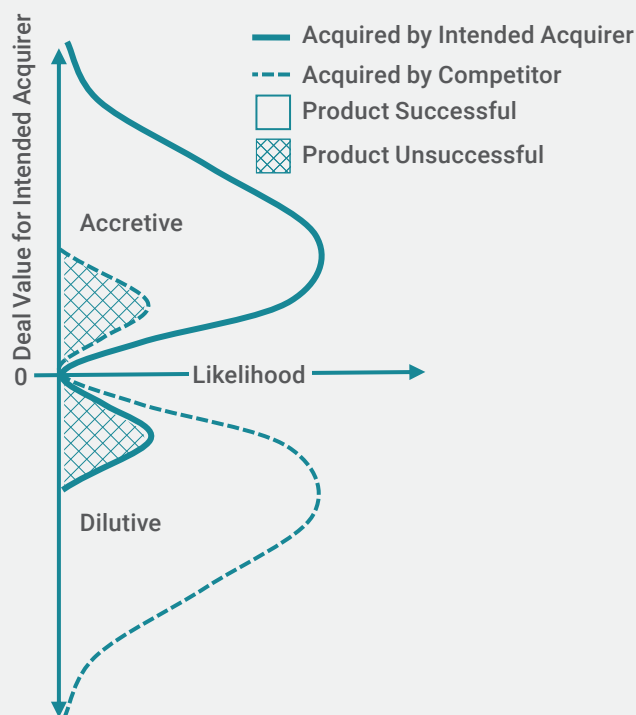
Source: Outcome Capital

Likewise, the Intended Acquirer will achieve a poor outcome if they purchase an unsuccessful product or their competitor acquires a successful one. Ultimately, the Intended Acquirer is weighing the risk that the desired product will be unsuccessful versus the risk that they lose a successful product to their competitor. If the Intended Acquirer is not yet participating in the market segment, loss of the deal to a competitor may pose little concern and their focus will be on product risk alone. However, if the market segment is a strategic imperative, the risk of losing the asset to a competitor may outweigh the inherent product risk.

Acquirer Perceptions of Risk From an Emotional Perspective

Ideally, all parties to a transaction would take a purely analytical approach and eliminate the impact of emotion. In reality all stakeholders are subject to emotional considerations, cognitive biases, misperceptions, imperfect data, and information asymmetry. A consistent misconception is that M&A

Figure 2
Transaction Value Impact From Target Acquisition by a Competitor



Note: Expected value of a transaction demonstrating a bimodal distribution and incorporating the impact of target acquisition by a competitor. The Intended Acquirer minimizes downside risk by comparing the likely impact of completing a poor transaction versus that of their competitor completing a good one.

Source: Outcome Capital

transactions consist of a formal process where: 1) companies have a set of well-defined acquisition objectives derived from an umbrella corporate strategy, and 2) buyers and sellers will evaluate the target company based on a detailed quantitative analysis toward a rational decision that is devoid of emotion, sentiment, or self-interest. However, we observe that executive decision-making is often irrational and driven by intuition, gut, and instinct. Those who wish to complete a successful transaction will strive to understand and account for the nonanalytical factors at play.

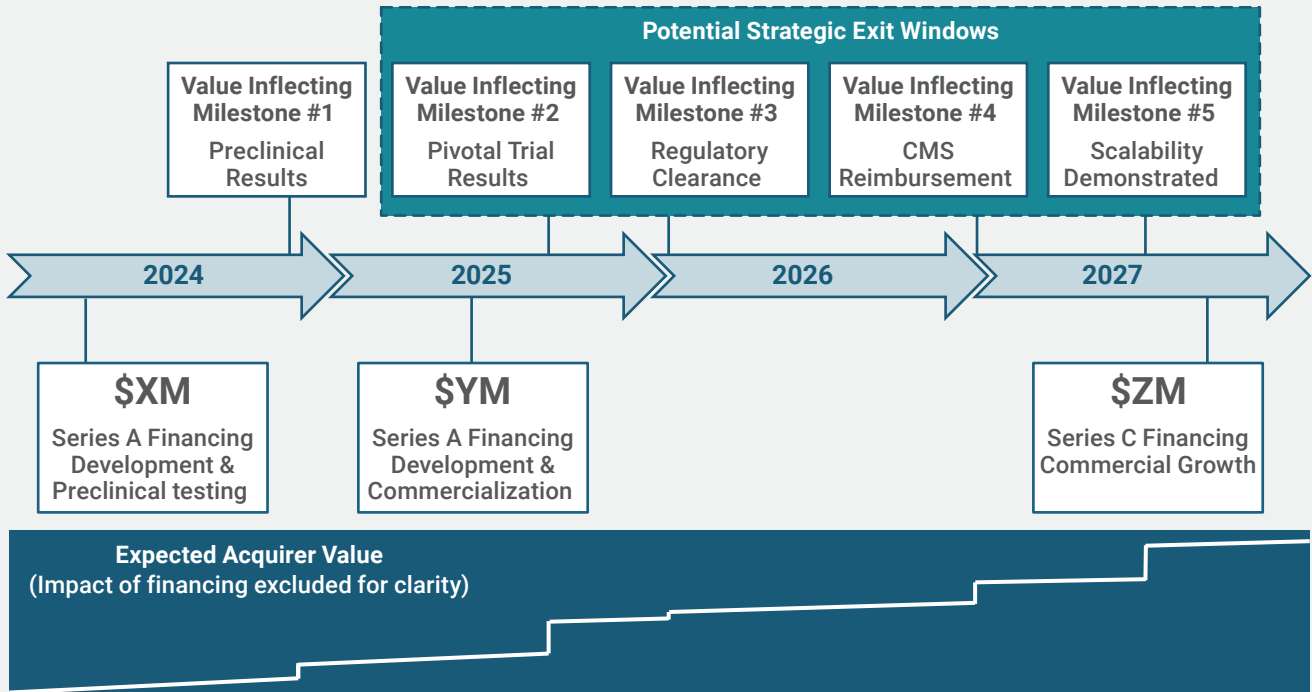
This dominance of conclusions over arguments is most pronounced when emotions are involved, particularly on the buy side of the transaction. In the case of prospective acquisition of a smaller company by a larger one, the seller management anticipates a direct financial benefit from the transaction, while the buyer’s representative will only benefit indirectly through enhanced reputation and increased likelihood (but not guarantee) of a year-end performance bonus. Sell-side CEOs who are favorably disposed toward their technology and have promoted it through multiple capital raises tend to rate their

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technology as offering large benefits and imposing little risk. This in turn fuels their overconfidence as to the successful outcome of M&A efforts in terms of both speed and valuation.

The emotional considerations for the buyer’s representatives can be more complex. In most large organizations, the downside risk

Figure 3
Paths to Liquidity for Investors, Paths to Value for Acquirers



Note: Path to liquidity with corresponding expected acquirer value. The impact of financing events and necessary investments is excluded from the expected acquirer value graph to highlight the impact of value-inflecting milestones. In this hypothetical example, successful pivotal trial results, CMS reimbursement, and demonstration of scalability are expected to create more value than regulatory clearance.
Source: Outcome Capital

of entering into an ultimately unsuccessful transaction may be given far greater weight than the upside potential (loss aversion bias). The individual may be more concerned with a poor deal damaging their career than with a good deal enhancing it. Since it is far easier to kill a prospective deal than to defend it, increasing the number of approval layers inevitably decreases the likelihood that any given transaction will be approved.

Because investment considerations are not purely analytical, the leaders of the target company that wishes to be acquired should not rely solely on their own personal judgement of which risks are most relevant to a transaction. Rather, they need to understand the risks as perceived by the would-be acquirer, whether justified or not, and make plans to mitigate them. "The market is always right," meaning it is the buyer rather than the seller who determines which risks are most relevant. From the perspective of the acquirer, the mitigation and retirement of those key risks will be the most important development milestones to be achieved. Going back to our value equation, reducing risk maximizes transactional value for all parties. The

success mitigation of each key risk represents an inflection point in the overall target company value.

Return on Invested Capital for Risk Mitigation

Risk mitigation is not without cost. It is therefore critical that prospective sellers make judicious investment decisions with an eye toward maximum value to their shareholders. One of the most common mistakes made by leaders of young companies is the failure to appreciate that the return on invested capital may vary significantly between different stages of corporate development. For example, the return on capital invested in product development and market development is likely to be significantly higher than the return on investment in commercial scale-up. While generally true from the perspective of the young company, this is especially true for the would-be acquirer that does not wish to pay for sunk costs into assets they don't need. A strategic acquirer that expects to leverage its existing commercial organization will place less value on commercial investments by the younger company compared to prior

Case Example: Consideration of Complex Acquisition Risk

In 2011-2013, **Covidien** sought to complement its vascular interventions portfolio with a novel abdominal aortic aneurysm endograft and identified **Endologix** as a potential acquisition target. At that time, Endologix's market capitalization was so high that an acquisition would only be attractive for Covidien if the combined entity achieved widespread adoption of the Endologix *Nellix* device. Yet there was considerable uncertainty regarding the market prospects for *Nellix*, particularly in the most common types of aneurysms where alternative products were widely available. The Covidien team determined that

the typical High Case/Base Case/Low Case financial model would be insufficient to address the complexity of the potential outcomes. Instead, the team developed a probabilistic deal model to better capture both the magnitude and the likelihood of various potential outcomes.

The market opportunity was broken down into five different subsegments defined by patient anatomy and pathology. A survey of leading vascular surgeons was performed to generate the most accurate forecast possible of future clinical adoption in each segment, accounting for

physician perceptions of the competing alternatives and the directional but incomplete clinical evidence available for the new *Nellix* device. This data was then fed into a Monte Carlo simulation of the acquisition financial model to understand the probability distribution of possible financial outcomes.

A Monte Carlo simulation is one that replaces one or more traditional static input variables with probability distributions based upon the best available information. The computer model then runs thousands of times, each run allowing the input variable(s)

investments in product development, clinical evidence, and market development.

Many young companies are mistaken in the belief that strategic acquirers insist upon a specific revenue threshold before considering a transaction. This misperception is often exacerbated by brief and superficial conversations with strategics in which they are actually provided a revenue target. More often than not, however, we find that this “revenue target” is simply a convenient shorthand for lingering concerns about one or more key commercialization risks. While meeting the prescribed revenue target could be one means to mitigate the perceived risk, there are often more cost-effective ways to bring the acquirer to the transaction table.

Strategic acquirers are looking for products ready to scale within their own commercial organization, products where the pricing, seller economics, customer economics, product positioning, and selling strategy have all been validated. The start-up may improve its return on commercial investment through focus on

demonstrating commercial scalability rather than by achieving commercial scale. Scalability is demonstrated by commercial success in a well-defined microcosm of the broader market opportunity. Often this microcosm is simply a small number of “representative” geographic territories, but it could also be a limited patient cohort, customer type, or insurance payor. For example, a seller that has achieved CMS reimbursement but not yet gained widespread commercial payor coverage may choose to demonstrate scalability through deep penetration in the Medicare segment with the assumption that private payor coverage will eventually follow suit.

Scalability involves showing commercial success with a clear product, marketing materials, and selling process. The attributes of the selected microcosm must be similar enough to the broader market to support an easy “leap of faith” by the prospective acquirer. For example, demonstration of repeated product reordering by experienced users may be more important than near-term gross margins if the future economies of scale are easily understood.

to vary according to their assigned probability distribution. Such models have limited value when there is only one key input variable but can be immensely valuable where there are a number of independent variables and high uncertainty regarding their “nominal” value. Simple plug-in tools are readily available to implement these simulations within traditional MS Excel deal models without the need for programming experience.

In the Covidien/Endologix case example, the team used the surgeon survey results to define a probability distribution for future market share of the *Nellix* device in each of the patient subsegments of interest. By capturing both the most likely outcome and the uncertainty of that prediction for each key input, this method added significant insight over static inputs alone.

The result of the Monte Carlo simulation of the Covidien/Endologix deal model is summarized in *Figure 1*. The range of Net Present Values (NPVs) for the proposed acquisition exhibited a bimodal distribution. The most likely outcome of the acquisition was an attractive >\$500 million+ NPV after including a purchase price of ~\$1 billion based upon Endologix market capitalization at that time. This scenario reflects the likelihood that *Nellix* would achieve number three market share or better in all patient segments. However, there was a real and significant possibility that the transaction would generate a negative ~\$100 million NPV for Covidien as evidenced by the shaded area in *Figure 1*. This lobe of the NPV probability distribution reflected the chance that *Nellix* would achieve market leadership in the most complex clinical cases but fail to gain

widespread adoption in more common aneurysms. While the most likely outcome was very attractive to Covidien, the potential for a negative return on the investment remained significant.

Based upon this understanding of deal risk, the Covidien leadership chose not to make an offer to acquire Endologix. Time has proven the wisdom of that decision—*Nellix* never achieved widespread clinical adoption. Endologix was acquired by Deerfield Partners during Chapter 11 proceedings in 2020 and has since pivoted to alternative product solutions that were not under consideration during Covidien’s 2011-13 analysis. Covidien eventually gained access to market-leading AAA endograft solutions in 2015 when it merged with **Medtronic**.

A nuanced understanding of value creation as perceived by the prospective acquirer may benefit the acquisition target immensely.

Transparent Path to Liquidity for Investors and Path to Value for Acquirers


Regardless of other motives, investors ultimately seek an attractive return on their investment. They want to know how much they are likely to gain, when liquidity is likely to be achieved, and what are the underlying investment risks. The savvy leader manages their relationship with investors in the same way they handle their development teams—with a clear set of financial objectives and value-added, de-risking milestones. Investor's focus will be on value-inflecting milestones, that is, that subset of corporate development milestones that represent significant inflection points in company valuation from the perspective of potential acquirers. In most cases, these value-inflecting milestones reflect mitigation or retirement of fundamental business risks. Laying out those milestones in terms of timing, investment, and valuation impact creates a clear path to liquidity for prospective investors and a path to value for the acquirer (see *Figure 3*).

An example of a clear path to liquidity for prospective investors as well as a path to value for potential acquirers is shown in *Figure 3*. To be useful, this tool must depict *the actual perceptions of prospective acquirers and not the wishful thinking of start-up management*. A nuanced understanding of value creation as perceived by the prospective acquirer may benefit the acquisition target immensely. In this example, would-be acquirers of a given technology believe that regulatory clearance is just a matter of time following successful pivotal trial results. If strong pivotal trial results mitigate the vast majority of regulatory risk, the resulting inflection in company value coming from the clinical trial results will be greater than that expected from subsequent regulatory clearance. The start-up executive could use this insight to begin negotiations before regulatory clearance is granted, confident that most of the value has already been achieved.

In addition to internal strategic planning, the path to liquidity concept directly supports multiple transaction options. Providing a clear path to liquidity engenders trust and demonstrates a mature alignment of company and market, as well as an understanding of the M&A marketplace, thereby attracting sophisticated investors. The same data becomes a basis for M&A discussions with industry strategics by aligning both parties to the upcoming transaction catalysts and their expected impact on deal valuation. This tool may also be used to support a potential structured deal by clearly establishing the post-transaction value-inflecting milestones.

Conclusion

Investors are motivated by the prospect of a timely return on their investment in the face of perceived risks. Sell-side CEOs attempt to create shareholder value through managing their business to a set of development milestones.

Strong leaders manage their teams to a set of carefully selected milestones that they believe will create value for their shareholders. However, it is the perceptions of the prospective acquirer that will have greater impact since it is their interest that will likely determine the timing and value of the future investor liquidity event. Buyer perception of business risk is a key determinant of overall transaction value, often incorporating complex analytical and emotional components that must be considered. Sell-side CEOs need to understand and judiciously mitigate buyer risk to maximize value for both parties. The savvy medtech leader will establish clear line-of-sight to their final liquidity event by defining their exit options, understanding what prospective acquirers truly want, building to those value-inflecting milestones, and sharing their learnings with investors and acquirers alike. 



PETER MEYER

Peter Meyer, PhD,
(pmeyer@outcomecapital.com)
is a Managing Director of
Outcome Capital.



ODED BEN-JOSEPH

Oded Ben-Joseph, PhD, MBA,
(oben-joseph@outcomecapital.com)
is Outcome Capital's Founder and
a Managing Partner.