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The Strategic Healthcare M&A Report

A Review of Merger, Acquisition and Strategic Transactions in the Healthcare Industry

July 2006, Q2 '06

Critical Corporate Advice

The Key to Maximizing Value in Healthcare Transactions -- Focus on Operations

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Recent years have seen a high level of transaction activity in the U.S. healthcare sector. Driving this activity are the attractive growth profile of healthcare-related companies and need for many of middle market manufacturers to partner with larger companies or private equity firms for access to market and/or capital in order to fully realize the commercial potential of their products. Yet, in conducting acquisitions, financial and transactional matters often overshadow key operational improvements that might be made to enhance a deal's ROI. This article focuses on key areas that can unlock value for an acquirer and, separately, for a selling company.

HEALTHCARE SECTOR DYNAMICS

With the aging population and medical technology innovation, U.S. healthcare spending has been dramatically growing and various healthcare sectors expanding. For example, consumption of Electromedical and Electrotherapeutical Apparatus grew at a 12.9% CAGR from 1998 to 2003, outstripping the overall U.S. Manufacturing growth rate of 1.9% for the same period.

Taking advantage of these growth opportunities, however, raises challenges, especially for innovative companies. A lengthy FDA approval process requires a large, protracted up-front investment with no certainty of commercialization success. Also, multiple purchase decision influencers (e.g., physicians, hospitals, HMOs) require a large salesforce, broad product lines, and/or strong relationships with Group Purchasing Organizations (GPOs) and distributors. To overcome these and other challenges, smaller companies often find it beneficial to access capital by partnering with private equity firms or joining forces with larger companies that have well-established sales forces and/or strong relationships with end-users.

For larger companies, acquiring smaller, focused companies allows them to fill the gaps in their product lines and leverage their infrastructure to generate growth. Private equity firms' interest in this sector is driven by the opportunity for significant value creation – fortifying companies with predictable top-line growth opportunities, defensible market positions and solid profit margins, especially in niches left open by the dominant industry players. This interest is evident from the results of our firm's recent Annual Survey of Private Equity Firms, in which a significant number of respondents identified the healthcare sector as a focus area.

For all who participate in this sector, certain realities should make operational efficiency a priority concern for several reasons. Among them:

- In high-growth situations, operations tend to be less efficient as management's focus is typically on the top-line.
- Operational problems and opportunities may not be apparent to existing management, who may be the architects of how the company is run and lack an outside perspective.
- Healthcare service companies are often good candidates to benefit from the rigorous process orientation of the manufacturing world.
- The potential for litigation is an ongoing threat in the healthcare sector, making it important to maximize value to justify the risk.

BUYING A COMPANY: KEYS TO SUCCESSFUL OPERATIONAL DUE DILIGENCE

Because the market dynamics are so favorable for the healthcare sector, it is important to not get carried away by the "growth story" and overlook operational fundamentals that, in the end, can make or break a deal. Whether a private equity firm or a corporate acquirer, during the buying process, it is critical to have a reliable fact-based understanding of whether and how operations can deliver (or fail to deliver) on projected financial performance or synergies. This is especially important when targets are smaller companies, as they often lack management and operations sophistication, resulting in less-than-optimal processes and controls, inaccurate/misleading reporting, and a poor understanding of cost and risk.

Astute buyers validate their investment thesis by carefully analyzing operations. They conduct incisive due diligence to uncover both operational problems that may be masked by standard financial reporting and hidden potential that may justify a winning bid. Rigorous operational due diligence signals when to persist in the purchase of a target and lays the groundwork for quick capture of operating value after closing.

While routinely bringing in specialists to address legal, accounting, environmental, and other aspects of due diligence, buyers have tended to over-rely on finance people (transaction staff and accounting firms) and the existing management team of the target for operational assessment. More often than not, such assessments are "top-down" in nature, failing to "get under the hood", thus missing out on critical front-line data and first-hand observations. Certainly, conventional techniques – standard benchmarking, ratio analysis, and financial measures – can provide one snapshot of a business' current operations. But, because these methods are overly simplified, this approach can mask significant operational opportunities and/or pitfalls. Interviewing existing operations management can supplement conventional techniques, but managers may be too accepting of the status quo and not challenge their own vision to uncover pitfalls and opportunities.

To quickly identify operational issues that represent problems or upside potential, a "freestanding" operational due diligence model is required. To be "freestanding", the model must be focused on key operational metrics, incorporate as much objective actual data as is possible, and correctly weigh and interpret the impact of assumptions leading to various scenarios of operational outcomes. Finally, the model must translate these outcomes into financial measures and implications.

Properly defined operational metrics are more predictive than financial data and can spotlight specific problems, as well as improvement opportunities. There is no universal set of measures for assessing operational performance, but this task can be accomplished relatively quickly by selecting the leading indicators that are most relevant for the business at hand. Typically, these measures are centered around cost, capacity utilization, working capital management, and customer service, with the particulars dependent on the type and com-

Key Operational Focal Points in Making an Acquisition

- Are recent operating margin trends stable and accurate predictors of future performance or will margins drop soon after closing as temporary measures lose their impact (*e.g.,* expiring favorable contracts, lower unit pricing driven by over-purchasing, better overhead absorption from building inventory, staff over-reductions that will negatively impact performance over time)?

- Are current working capital requirements stable or will additional investment be needed (*e.g.*, building inventory to maintain customer service requirements, reducing abnormally high days payables outstanding to quell vendor dissatisfaction)?

- Are estimated Capex requirements accurate or have operations been held together with "band-aids" and require significant future spending?

- Are processes sufficiently institutionalized to remain steady through the loss of key personnel?

- Can the president and senior staff expand the company and operate under heavier debt structure and reporting requirements?

- What are other operational vulnerabilities (*e.g.*, reliance on a vendor or customer, disruption from technology upgrades)?

- How realistic are management's currently identified opportunities/ projections (*e.g.*, over-optimistic automation or outsourcing plan that may create disruption or quality problems and/or not deliver targeted savings)?

plexity of the business. For example, if a company has high number of SKUs to meet diverse customer requirements (which may be driven by preferences and policies of individual hospitals/doctors), the key measures to focus on are inventory turns and on-time delivery rates. For a manufacturing company, the key measures may be labor efficiency, material yield, and product quality.

This type of modeling, with its fact-based foundation, enables objective evaluation of the target's operations, as well as an "apples to apples" comparison with comparable operational metrics of best-in-class players in the same and other industries. Only in this manner is the "top-down" melded with the "bottom-up" to provide well-informed scenario analysis of what is possible and likely from operations.

SELLING A COMPANY: KEYS TO MAXIMIZING VALUATION

For sellers, skillfully marketing the company's future operating value potential to prospective buyers is critical in maximizing valuations. However, sellers often emphasize market potential to the detriment of operational analysis and potential. In fact in performing operational due diligence work on behalf of buyers, we often find operational improvement opportunities that have not been put on the table by the seller, with the buyer ending up the beneficiary, rather than the seller.

To present a complete picture of operations potential, the seller must first conduct a thorough diagnostic to identify areas of improvement that will create future value, as well as leverage points in operations that can create a competitive advantage for the company. Key questions to address include:

- What additional opportunities can be found within existing operations?
- What is required to elevate operational capabilities and performance within the next 1-2 years, and what is the scope of such opportunities?
- What are the investment needs and correct priorities to capture these opportunities?
- How can the projected operational capabilities drive long-term strategic advantage?

Once the diagnostic is completed, the findings and opportunities should be shared with prospective buyers in the form of a focused plan that clearly shows the path and requirements to capture the identified opportunities. It may not be necessary to implement the plan, although taking some cost-efficient steps to demonstrate the plan's validity is worthwhile. Even if some investment is made – *e.g.,* for important new equipment or IT systems -- and the fruits of this investment may not be immediately realized, the value of this investment can be captured by the seller in negotiations by creating credible pro forma financials and making a substantiated case that gives effect to the expected growth and profitability to be realized from the investment.

Doing so allows sellers not only to talk about current performance but also to make an upside case to buyers which should drive the valuation to a higher level. Most buyers are willing to pay the full (and maybe a premium) price for a company that is "well-run" and has clear plan for where to go next.

CONCLUSION

Even in high growth, top-line focused sectors like healthcare, buyers and sellers who maximize value are those with access to operational expertise that can be infused throughout the full investment lifecycle – from due diligence to closing, integration and beyond.

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Possible Measures to Enhance Value as a Seller

- Develop and start implementing a cost reduction plan which may include vendor consolidations and renegotiations, labor productivity improvements, overhead reduction, facility consolidation, and outsourcing.
- Develop a plan for making the supply chain more efficient, reducing inventory costs and levels, enhancing customer service, and improving logistics.
- Conduct an assessment of operational capabilities of competitors and customer requirements to identify potential areas of operational improvements that may deliver a competitive advantage and solidify/improve the company's growth potential (e.g., reduction in order lead time, customization, maintenance/service capability).

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