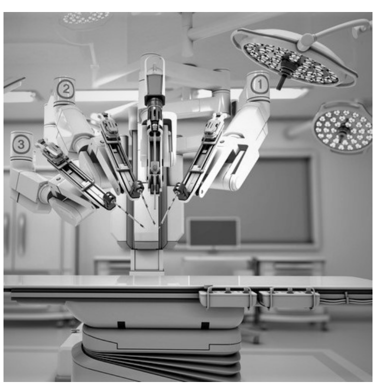
Healthcare Partnerships:
Playing to Win in Medtech Dealmaking

By Molly Farber

Healthcare companies, facing new and unprecedented pressures from regulators, competitors, and consumers, continue to turn to dealmaking – by way of M&A, joint ventures, and other forms of partnership – as a means to survive in the industry's new world order. Previously, we've profiled the drivers and models of deals among payers, providers, and pharmacy companies, though we have yet to touch upon an adjacent segment – medical technology – where dealmaking is unfolding in a distinct but interrelated manner.



Recently, Water Street sat down with Rick Anderson, Managing Director of PTV Healthcare Capital, a late-stage venture and expansion capital firm based in Austin, TX, and Greg Davis, CEO of MedCelerate, a consulting group that supports the growth of medical device companies through manufacturing and commercial ramp-ups, and Adjunct Professor at the Fuqua School of Business at Duke University. We discussed highlights of dealmaking trends among medtech companies today and talked about how companies in this sector are leveraging particular types of deals to propel innovation.

DISRUPTIVE DYNAMICS IN HEALTHCARE AND THE IMPACT ON MEDTECH

The evolution of the U.S. healthcare industry has been a matter of both regulatory change – principally catalyzed by the Affordable Care Act (ACA) and its imperative to shift the industry's business incentives from "volume to value" – in addition to transformation compelled by macro-trends like the rapid advancement of technology and big data and their increasing accessibility to individual consumers. The impact on medical device, or medtech, companies is multifold: they are experiencing the pressure of reimbursement cuts indirectly through interactions with their customers, and they are also witnessing out-of-industry companies like Apple and Google testing capabilities in the traditional medtech domain.

Consolidation between and among payers and providers, who represent key customers of medtech, has contributed to parallel consolidation trends among device companies. Greg Davis notes that medtech companies have observed intense provider consolidation and reacted accordingly: "Medtech companies are continuing to consolidate at a rapid pace, making a scale and size play. Especially as payers and providers grow more consolidated, this approach helps the medtech players remain at the negotiating table, by enabling them to talk about a wider range of products." Moreover, Rick Anderson points out that device companies, particularly those in commodity categories, are "facing tremendous pricing pressure" from payers and providers, and have reacted by leveraging acquisitions in an effort to, "get too big to ignore – they want to ensure that the payers and health systems and integrated delivery networks have to pay attention to them."

The shift in traditional purchasing dynamics for devices has also impacted how medtech companies approach selling, as they increasingly need to engage a larger stakeholder group and acknowledge the emerging emphasis on value. According to Davis: "for decades, the med device industry has been focused on the physician as the key decision maker. But now many physicians are employed by hospitals; while they're still at that negotiating table, they're only a single voice at the table today." Additionally, medtech companies are responding to the needs and preferences articulated by their customer base and regulators by increasingly considering broader contracting arrangements that cover larger product sets and reflect the emphasis on value and risk-sharing that is ubiquitous today among payers and providers. Davis says that device companies are expressing "interest in getting into the services side of the business; they're talking about developing more complete packages that might mean they get paid based on the continuum of care, rather than for a particular implant or other device."

That said, Rick Anderson suggests that there's an element of dissonance between what many medtech companies communicate publicly versus carry out in day-to-day business operations: "They're saying all the right things and claim to be figuring out population health, but the absolute truth is that most are really doing nothing about it – in fact, if they were really to enable population health initiatives, it would disrupt their business model; having to deal with things like risk-sharing would be inconsistent with how they sell their products."

Medtech companies' lack of substantive action on the population health front has facilitated the entrance of out-of-industry players like IBM and Alphabet (Exhibit 1), who, in Anderson's words, are "looking over the fence at healthcare, and saying, 'we can innovate in that space.'" While medtech companies collect and manage enormous amounts of data, Anderson and Davis suggest that technology companies like IBM Watson and Verily are the driving force behind new data analytics partnerships with established medtech players like Medtronic and Johnson & Johnson. Anderson says, "the people who are really doing something on this front are the data people, like those at Verily; it's those tech companies who really understand the value of the data, and medtech is chasing rather than leading those partnership conversations." While early examples of these partnerships like Verb Surgical and Galvani Bioelectronics still have yet to launch major product offerings, Anderson and Davis agree that the wealth of data housed in the medtech space is likely to continue attracting the attention of out-of-industry innovators.

Exhibit 1: MedTech Deal Activity by Out-of-Industry Companies

Technology Company	Deal Activity
Qualcomm	1. Series of nonexclusive strategic collaborations leverage Qualcomm platform for secure data collection and connectivity and enable development of remote patient monitoring solutions – partners include: **Roche, Walgreens, Novartis, Cerner, Johnson & Johnson, Philips** *(January 2015-ongoing)* 2. Joint investment company with **Novartis** to support early stage healthcare technology, product, and service companies *(January 2015)*
GV – Google & verily	1. **Verb Surgical** – joint venture with Johnson & Johnson intended to develop surgical solutions platform with robotic capabilities *(December 2015)* 2. **Onduo** – joint venture with Sanofi to develop diabetes management solutions, leveraging devices, software, and clinical services; Sutter Health and Allegheny Health Network are early health system partners *(September 2016)* 3. **Galvani Bioelectronics** – joint venture with GSK focused on developing and eventually commercializing bioelectronic therapies *(November 2016)*
IBM Watson	1. Acquired **Merge Healthcare** for $1B to integrate imaging capabilities and data with the Watson "Health Cloud" platform; preceded by IBM acquisitions of Explorys, Phytel *(August 2015)* 2. Strategic collaboration with **Medtronic** to develop predictive diabetes management solution, applying Watson machine learning algorithms to data collected through Medtronic devices *(April 2015)* 3. Alliance with **Siemens** Healthineers division builds upon broader (and not exclusively medtech) IBM-Siemens partnership to develop and sell population health management solutions to provider customers *(October 2016)* 4. Channel partnership to sell Watson for Genomics' molecular data interpretation technology in China through **Baheal Pharmaceutical Group** *(June 2017)*

Source: Press releases & public filings – Water Street analysis

POSITIONING FOR SUCCESS – EMERGING MODELS FOR MEDTECH DEALMAKING

In reviewing industry dynamics and the deal activity of medical device companies, Anderson and Davis describe a cast of archetypes that are likely to emerge as various players leverage different strategies – and more specifically, types of deals – to cope with industry-wide disruption. Anderson observes, "bigger companies are deciding, as we speak, whether to be 'too big to fail' or to be technology innovators." He comments that the largest global players like Johnson & Johnson are more likely to choose the former, because, "they're giant players with an unmatched global footprint; their strategy will be to occupy categories where they can win with scale." Companies like these, in Anderson's opinion, may invest modestly in innovation, but generally will play a consolidator role, operating under the assumption that "they can buy whatever they want at whatever price."

Anderson also describes an alternative approach, in which companies like Siemens, GE, and Philips seek to vertically integrate and make targeted investments in particular services and therapeutic areas. The key to making this a winning strategy, according to Anderson, is to pick the right verticals that are well-positioned for innovation.

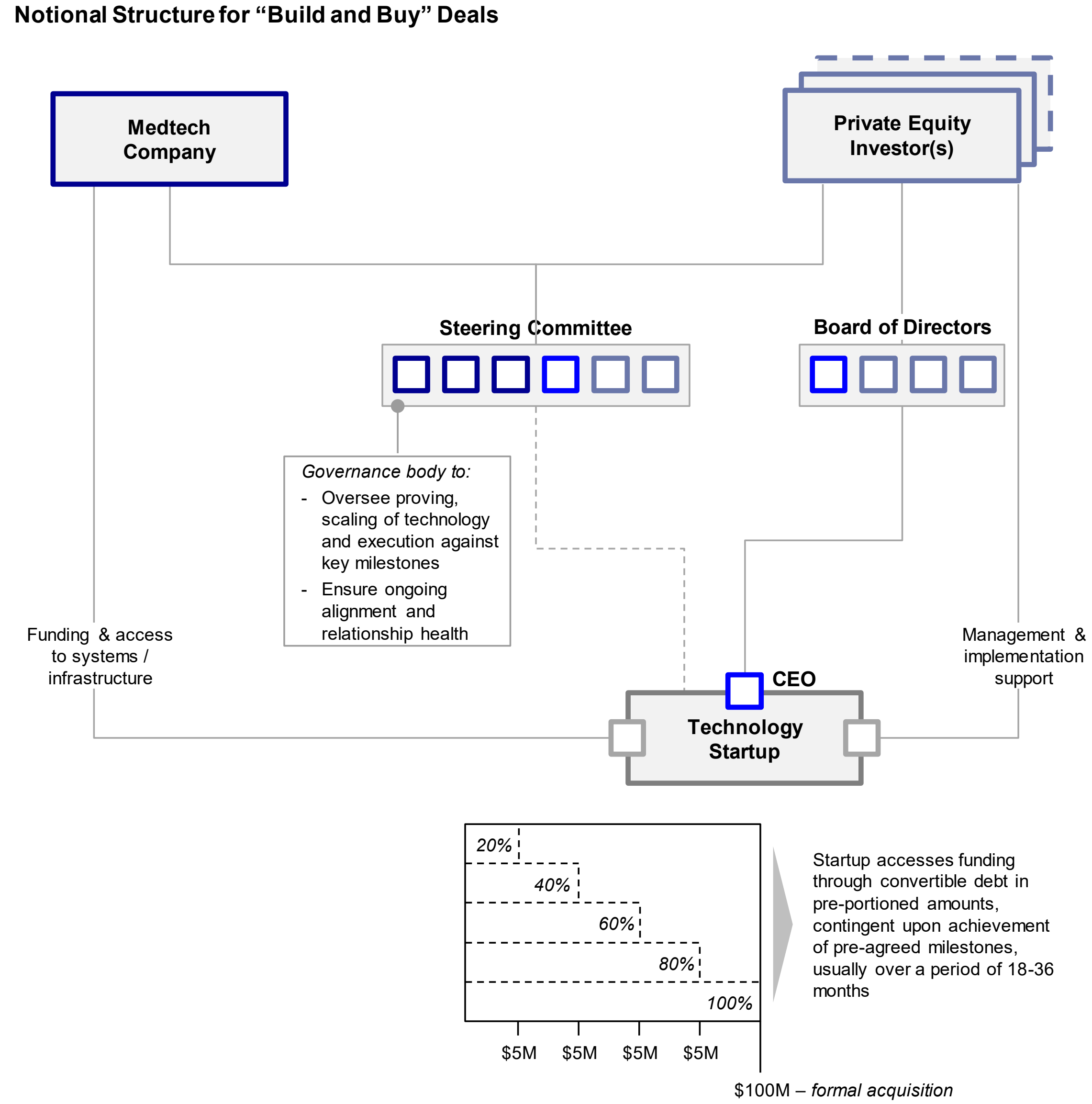
Underpinning both of these approaches is a heavy preference for acquisition on the part of traditional medtech companies. In Davis' words, "large medtech companies have historically relied on a model of buying innovation from small companies, and then throwing it into their big company sales engines." However, both Anderson and Davis point out the pitfalls of this attitude, commenting, "after the financial crisis, throughout 2008-2009, there was almost zero startup activity in medtech – the largest hole ever in our industry is playing out right now, and the big companies are complaining that there's nothing to buy." Anderson says, "the biggest medtech players are blindly going about what they've been doing, thinking the ecosystem will produce more companies – when in fact, the tech folks like Qualcomm and Google see this as an opportunity to come in and disrupt their businesses."

CREATIVE APPROACHES TO MEDTECH DEALS

Faced with a shortage of conventionally attractive acquisition targets, some medtech companies are turning to partnerships and creative deal terms to alleviate the stress of investing in early-stage, high-risk startups. Anderson remarks that while large device companies are "starving for growth," many remain reluctant to make investments that are not accretive on day 1. Moreover, there's real risk of crushing new startups with heavy corporate structures, policies, and management. That said, Anderson argues, "there's an awakening happening – these companies are realizing that they can support off-balance sheet R&D units, and then leverage their global footprint to sell and share margin."

Arguably the most creative of these partnership structures are what Anderson calls "build and buy" deals (Exhibit 2), a form of synthetic joint venture or phased acquisition between a startup technology company and its venture capital or private equity partners on the one hand, and an

Exhibit 2: Build and Buy Deal Structure



Source: Water Street Partners Analysis

established medtech player on the other. The parties pre-agree to an overall partnership timeframe, development and other milestones, incremental funding commitments, exit ramps, and other key deal terms. As the partnership launches and progresses, the startup company gets access to capital in pre-agreed portions – by way of convertible debt, off of the larger company's balance sheet – as it achieves the predetermined milestones. Those milestones pertain not only to proving and scaling the technology in question, but also may include integrating the startup organization and its capabilities into the larger company's structure and product suite. If successful, the larger company will officially acquire the startup at the end of the programmed collaboration period, having already proven out the technology, tested the relationship, and proactively addressed the logistics of integration.

There are several clear benefits to this type of deal structure. In leveraging a "build and buy" deal, large medtech companies have an opportunity to more exhaustively vet and nurture emergent technologies before taking major hits to their P&Ls. Startups receive the funding they need, but – in Anderson's words – avoid being "tinkered to death" by the corporate structure and processes of an established medtech company. Looking ahead, Anderson believes that this type of collaborative transaction will be an appealing mechanism to de-risk key investments while fostering critical innovation in the medtech ecosystem.

~ ~ ~

Like most of the healthcare industry, Davis and Anderson agree that the medtech sector today is in a transitional period, anticipating a "tsunami" of digital innovation and beginning to leverage collaborative deals as a means to capitalize on it. The companies best positioned to succeed will be those who commit meaningfully to innovation and are willing to flex collaborative partnership muscles that have been neglected by medtech players historically. ℘

For questions on this issue, please contact:

Molly Farber
Director
Molly.Farber@waterstreetpartners.net

Water Street Partners LLC – About Us

Our Firm

Water Street Partners is the world's leading advisory firm on joint ventures. Our work focuses on negotiating and structuring venture transactions, managing the launch and integration process, and supporting owners, Boards, and management teams on improving and restructuring their joint ventures and other partnerships.

Based in Washington DC, Water Street Partners works on ventures across a range of industries, including energy and natural resources, technology, aerospace and defense, media, and consumer goods. Roughly 80% of our work is cross-border or involves partners from multiple countries.

Since 2008, Water Street Partners has directly supported more than 200 clients on ventures representing more than $480 billion in value.

Our Services

Water Street Partners supports clients in three ways:

Consulting – Customized support for clients working on venture negotiations and structurings, integration, governance, and restructurings.

Joint Venture Deal Advisor – An annual membership service providing dealmakers with access to: (i) an online suite of tools, guides, and sample contracts related to venture transactions; (ii) a database and case library of creative venture deals; (iii) networking opportunities; and (iv) on-call advice and support.

Joint Venture Advisory Group – An annual membership service providing JV CEOs, JV Board members, corporate center executives, and others with access to: (i) an online suite of tools and guides related to governing and managing joint ventures; (ii) networking and education opportunities; and (iii) on-call advice and support.

Our Publications

Water Street Partners has three publications:

The JV Deal Exchange (JVDX) – A publication targeted at dealmakers, aimed at providing provocative perspectives, practical tools, best practice approaches, and contractual terms that are directly usable in active deal negotiations.

The Joint Venture Exchange (JVX) – A monthly publication aimed at JV CEOs, JV Board members, corporate center executives, and others with a direct role in managing and governing existing joint ventures.

Water Street Insights (WSI) – A weekly online publication for all business audiences that expresses our views on a wide range of business strategy and general arrangement issues pertaining to joint ventures and alliances.

Water Street Partners

Editorial Team

ISSN 2329-4833

WSI