

# Industry Consolidation: Impact on Start-Ups and Innovation

Robert A. Hopkins, Equity Research Director at Bank of America, discusses the current motivators for mergers and acquisitions and the future of funding for medical device development.



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## Is the medical device industry consolidating faster or more significantly than it has in the past decade?

**Mr. Hopkins:** In a word, yes. Six of the 15 largest medical device companies announced agreements to merge in 2014 in three large-scale transactions. Additionally, several of the largest companies in medical devices have spun off or are in the process of spinning off major divisions. We have seen periods of significant consolidation in the past, but those took place more than 10 years ago.

What makes the current period unique is the magnitude of the strategic activity taking place among large companies. With 40% of the large companies involved in deals in 2014 and others splitting in two, it is safe to say that there is more large-scale activity going on today than at any time in the past decade. It's also worth noting that we have seen very few deals involving large medical device companies buying mid-sized medical device companies. There are exceptions of course, but most of the activity recently has involved larger companies merging with other large companies or larger companies buying small, early-stage companies for deal prices below \$500,000,000.

## Is the consolidation we are seeing in the cardiac and vascular space similar to that of other medical fields? What about nonmedical industries?

**Mr. Hopkins:** The level of consolidation in the cardiac and vascular space recently has not been similar to that in other medical fields. We have seen more activity in

orthopedics and general surgery and less in vascular. The cardiac and vascular space is relatively less commoditized than orthopedics. The potential consolidators in cardiac seem, at least for now, to be more focused on trying to drive innovation than cutting costs and preparing for a world of bundled contracts.

## From your vantage, what factors are driving these companies toward a faster rate of large-scale mergers and acquisitions?

**Mr. Hopkins:** Over the course of the last 3 to 5 years, most of the large medical device companies have hired new CEOs. This changing of the guard has not been the main driver of the recent unprecedented level of consolidation, but it has been a facilitating factor because the outgoing CEOs managed in an era of rapid, United States-focused growth. That era is clearly over, and the new CEOs, with less attachment to the world that was, have more easily seen the need for change.

The main drivers of the recent high level of activity have, in my view, been the quest for better access to global cash and global markets, the rapid consolidation in the medical device customer base (hospitals), and the view that over time, there will be major changes to the way medical devices are purchased in the United States as we slowly but surely move away from the fee-for-service model. These medical device companies are envisioning a future where the hospital administrators are as involved in the purchasing decision as the doctor, and a world where more hospital systems transition to at-risk payment models, where bundled contracts are more prevalent. In this world, medical device companies must find a way to be better partners with hospitals and have the ability to offer broad-based solutions. Lastly, pricing pressure in the medical device space has been and will continue to be relentless in our view, which adds to the pressure to merge.

**Do you see the shift toward more large-scale mergers as continuing in the near future? Is there any reason to believe it could slow, or reverse, with more spinoffs of some divisions into freestanding players?**

**Mr. Hopkins:** With only a few exceptions, most of the spin-offs in the last few years have involved companies separating pharma and biotech divisions from medical device and other health care businesses. The pure play medical device companies are more likely to increase in size rather than spin off certain medical device assets, in my view.

I see the potential for more deals, especially if the more narrowly focused companies start to lose share. To compete, medical device companies will either need to be able to consistently innovate at a truly differentiated level, or they will need to consolidate in our view. Importantly, this shift to at-risk models and more bundled contracts is likely to happen slowly. The pace of the change is uncertain, but the direction seems clear.

**What are some of the possible effects of large-scale mergers on start-ups of today and tomorrow? On innovation? Patient care? Employees of device companies?**

**Mr. Hopkins:** In part, consolidations are about cost savings, and cost savings mean fewer employees at medical device companies. Even beyond the consolidations, in my view, the medical device companies are likely to grow their employee base at a rate below revenue growth

and in some cases, shrink the employee base in absolute terms. If administrators become as important as doctors in making purchasing decisions, the need for the current high-touch sales model is diminished.

Patient care is unlikely to be affected in any negative way, as quality measures are becoming directly tied to reimbursement.

Regarding innovation, consolidation means fewer buyers of small innovative companies, which is a disincentive to invest in innovation. In my view, consolidation is a negative for innovation, but I am optimistic that other factors will continue to incentivize medical device innovation. Indeed, in the past few months, I have been introduced to more innovative medical device companies than at any point in the last few years. The absolute numbers remain small, but the increase is notable.

**How might venture capital investment in the industry change as a result?**

**Mr. Hopkins:** Venture returns for the medical device industry have been relatively terrible over the last number of years when compared to biotech. As a result, the number of funds investing in medtech has dropped. While consolidation will, on the margin, hurt innovation in my view, other factors are improving (regulatory), and I am optimistic that the net impact will actually be positive looking forward. ■