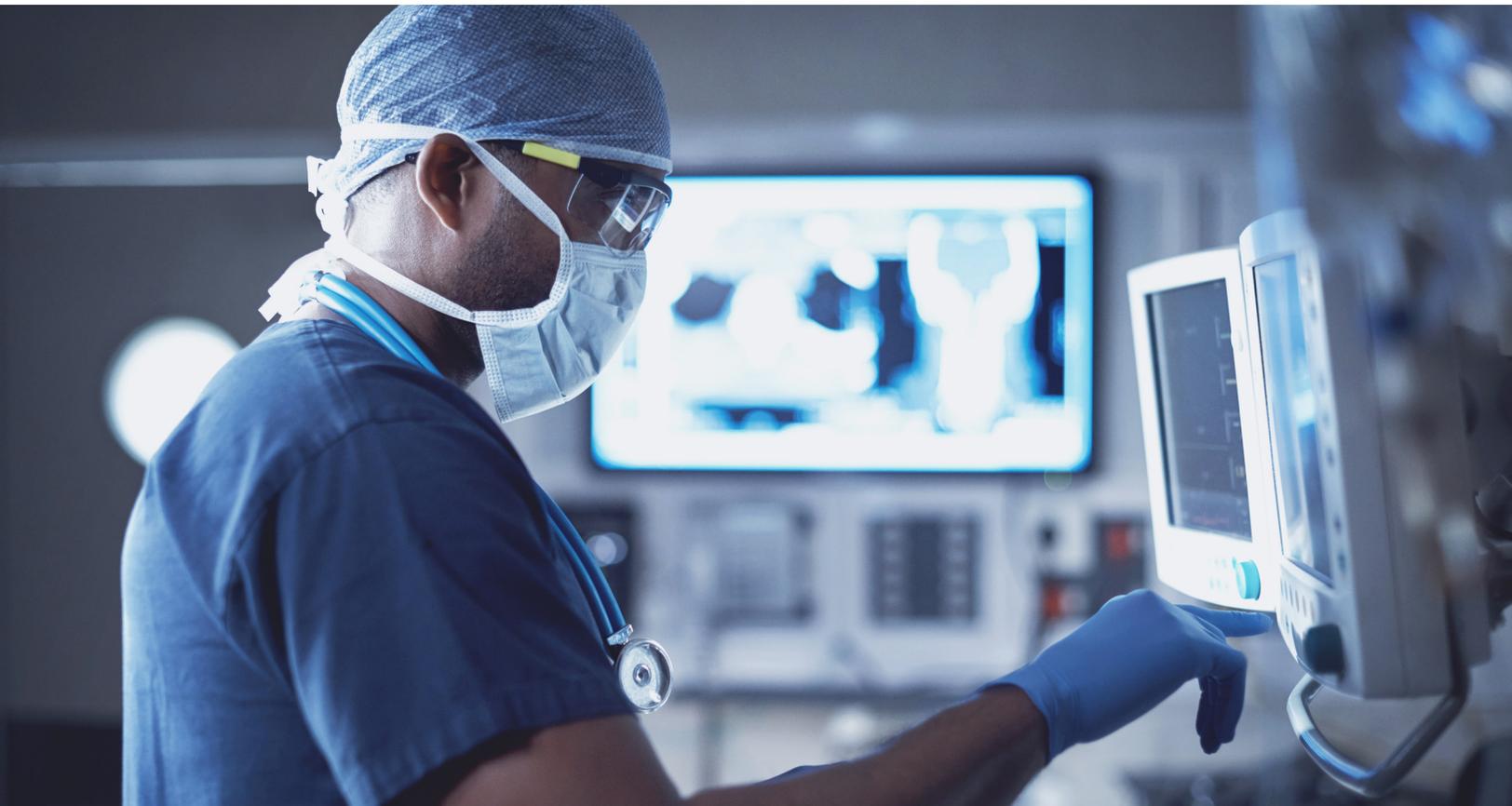


Pharmaceuticals & Medical Products Practice

Divestiture in medtech: Are you the natural owner of your businesses?

For medtech companies, divestitures can create value. But several elements are necessary to make separations successful.

by Josh Copp, Ruth De Backer, Gerti Pellumbi, and Julia Samorezov



As growth becomes more challenging in the medtech market, some companies are turning to M&A to build scale and enter high-growth segments. However, maintaining a competitive portfolio also requires companies to evaluate their portfolios regularly and divest noncore assets. In recent years, the global value of corporate divestitures (including spin-offs and carve-out sales to strategic or financial buyers) has grown steadily across sectors, from transactions worth \$1.7 trillion in total in 2010 to \$2.1 trillion of these transactions in 2017.

Medtech companies have contributed to that growth, with divestitures increasing in deal value from \$3.9 billion in 2010 to \$10.9 billion in 2017 (Exhibit 1). In three of the past five years, the assets they divested amounted to more than \$25 billion,

much of which came from larger divestitures, with at least one \$5 billion divestiture every year since 2013. Amid all this activity, medtech companies face an important task: taking a hard look at their portfolios with a view to eliminating noncore assets.

How do divestitures create value?

We reviewed the divestiture activity of 54 leading medtech companies over the ten-year period ending the first half of 2018 and drew three important conclusions from our findings.

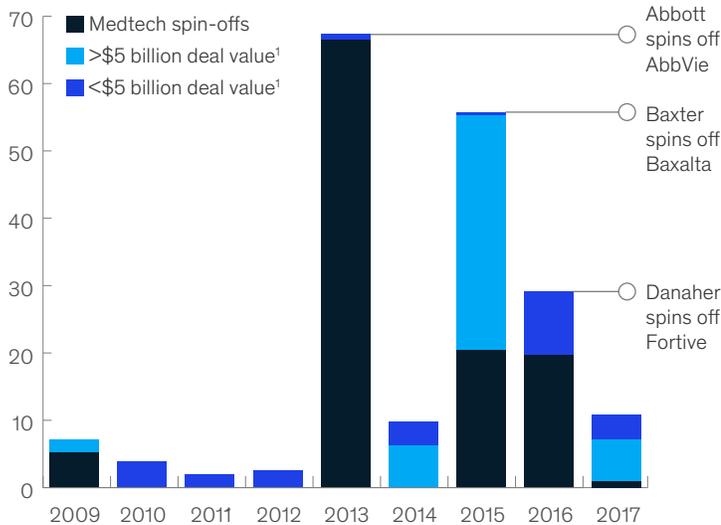
1. Divesting at scale drives excess total returns to shareholders for the parent company

Medtech-company divestitures generated excess total returns to shareholders (TRS) compared with the medtech industry, averaging about 2.2 percent

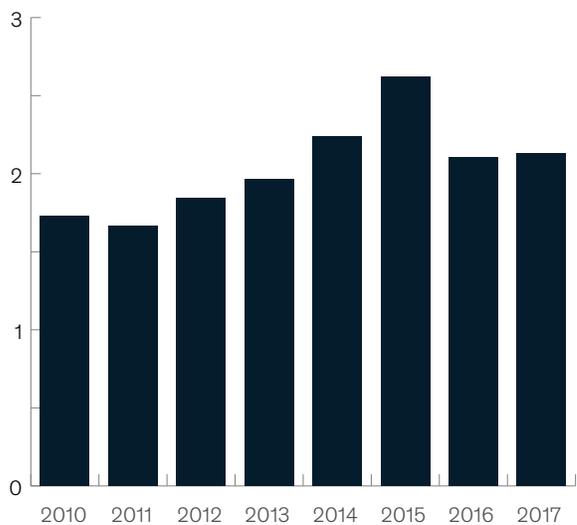
Exhibit 1

Medtech is outpacing overall industry growth in divestiture activity.

Global medtech divestitures, \$ billion



Total corporate-divestiture activity,² \$ billion



¹Divestitures with deal value >\$25 million, announced (not withdrawn) for 54 medtech companies.

²Divestitures with deal value >\$25 million. Includes equity carve-outs, spin-offs, and sales in which 100% of divested entity was acquired. Excludes divestments by private-equity and venture-capital companies.

Source: Dealogic; McKinsey analysis

two years after the divestitures were announced (Exhibit 2). Much of this value creation came from large divestitures: after two years, divested assets valued at more than \$1 billion yielded 5.1 percent in excess TRS, compared with just 1.3 percent for those of lower value.

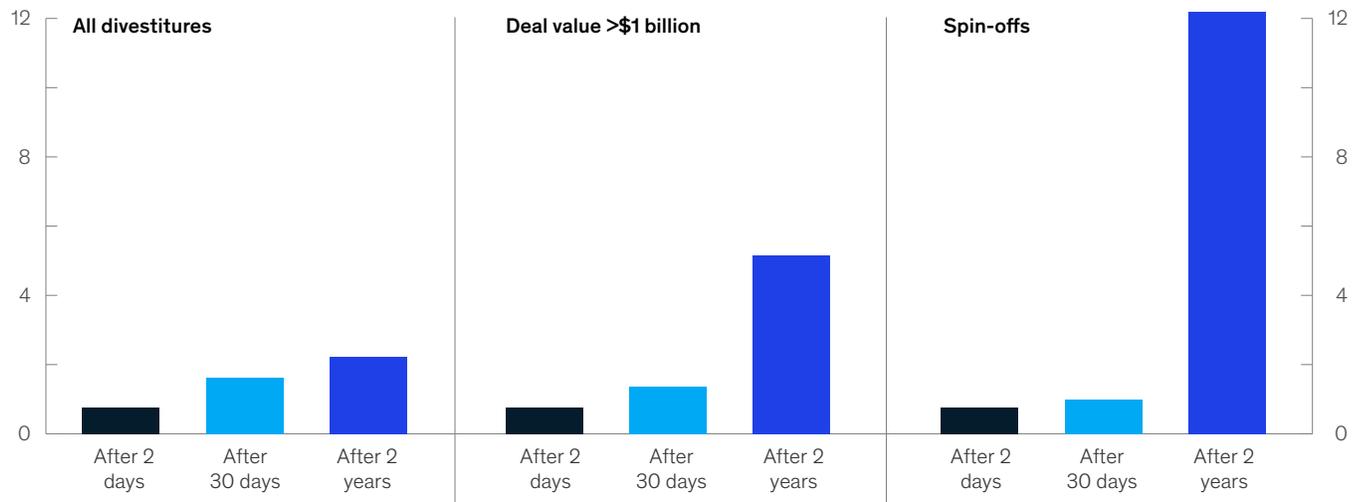
Large divestitures often happen when companies redefine their strategies to focus on a single sector. Examples include Abbott's spin-off of AbbVie in 2013; Baxter's spin-off of Baxalta in 2015; Medtronic's sale of its patient-care, deep-vein-thrombosis, and nutritional-insufficiency businesses to Cardinal Health in 2017; and, more recently, Siemens's spin-off of Siemens Healthineers, Novartis's announcement of its intention to spin off Alcon, and General Electric's announcement to spin off GE Healthcare.

The greater scale of incremental TRS from larger divestitures can partly be explained by the fact that only big deals can meaningfully change a company's portfolio and associated growth trajectory. In addition, larger deals may be more able to absorb the substantial transaction and divestiture costs incurred during the complex process of disentanglement. Further, smaller deals may require a more complex carve-out of parts of a business, while larger transactions are more likely to include a fully independent business unit, which decreases the execution complexity of a separation. In principle, a company could also reshape its strategy through a combination of smaller deals, but few medtech companies have followed this approach. Of the 26 companies that divested assets of \$25 million or more between 2007 and 2017, only eight completed three or more divestitures.

Exhibit 2

Medtech is outpacing overall industry growth in divestiture activity.

Excess total returns to shareholders by deal size,¹ %



¹Deals from 2008 to first half of 2018. Compared with MSCI World Health Care Index, healthcare equipment and supplies; 2-year excess total returns to shareholders calculated only for deals in 2008–16.

Source: Dealogic; McKinsey analysis

2. Earlier and more frequent divestitures generate more value

Executing divestitures successfully is far from simple. Earlier McKinsey research found that the majority of divestitures across a range of industries would have created more value if the businesses had been sold sooner, with a 30 percent increase in absolute return, over a ten-year period.¹ This holds true for medtech companies, which need to stay ahead of trends in reimbursement, clinical practice, technology, provider consolidation, and purchasing patterns. Tracking of such market trends can help to identify assets that may not align to a company's future priorities and can be used to flag them for potential divestiture early on.

As part of our analysis, we looked at a sample of medtech companies that divested assets over a ten-year period and compared the performance of "active divestors"—those that divested four or more assets over the period, taking action to reshape their portfolios every two to three years—with that of their less active peers. The sample size was small, with just five active divestors completing 36 transactions over the ten-year period. Even so, the results were interesting: these active divestors generated 2.3 percent in excess TRS, compared with 1.1 percent for those that executed three or fewer transactions over the ten-year period.

3. Spin-offs can create more value than other deal structures

A number of large medtech divestitures are spin-offs (seven out of 75 deals, six of them worth more than \$1 billion in value). As Exhibit 2 shows, these spin-offs generated 12.2 percent in excess TRS for the parent companies after two years. By contrast, parent companies that divested to a strategic buyer generated 1.0 percent in excess TRS after two years.

Our analysis of underlying drivers for spin-off showed that the businesses spun off had not been growing under the parent companies. In fact, they had shrunk by an average of 1.8 percent per year in the two years prior to spin-off. However, they

were able to restore growth after divestiture, with an average growth rate of 15.9 percent per year in the two years following spin-off (Exhibit 3).² Among the four companies with data available, growth rates for the divested businesses were at least five percentage points higher in absolute terms in the two years after spin-off than in the two years before.

For parent companies, spinning off shrinking businesses allows a renewed focus on their core businesses. In some but not all deals, spin-offs can also lead to growth improvements for the parent companies (three of four companies with data available showed growth improvements in the year after the spin-off compared with the year before, with an average growth rate accelerated by 4.9 percentage points). Within this same sample set, all four of the parent companies were able to sustain or grow their margins in the year after the spin-off compared with the year before. The message is clear: spinning off an asset is an essential option to consider when planning strategic divestitures, particularly when the business under evaluation already operates as a relatively stand-alone entity.

What is needed for a successful divestiture?

Companies seeking to identify appropriate assets for divestiture and execute a successful transaction need to ensure that several capabilities and enablers are in place to manage the divestiture. In this article, we focus on the more strategic and overall divestiture-management aspects. For a successful separation, the divesting company will also need to think through the actual separation execution (for example, transitional-service-agreement (TSA) management and exit); "NewCo" and "RemainCo" operating-model redesign, if applicable; and transaction enablement, including legal, tax, and financial activities to enable the transaction.

Fact-based portfolio evaluation

Portfolio evaluation is vital in any deal, but there are a few areas specific to medtech that are critical

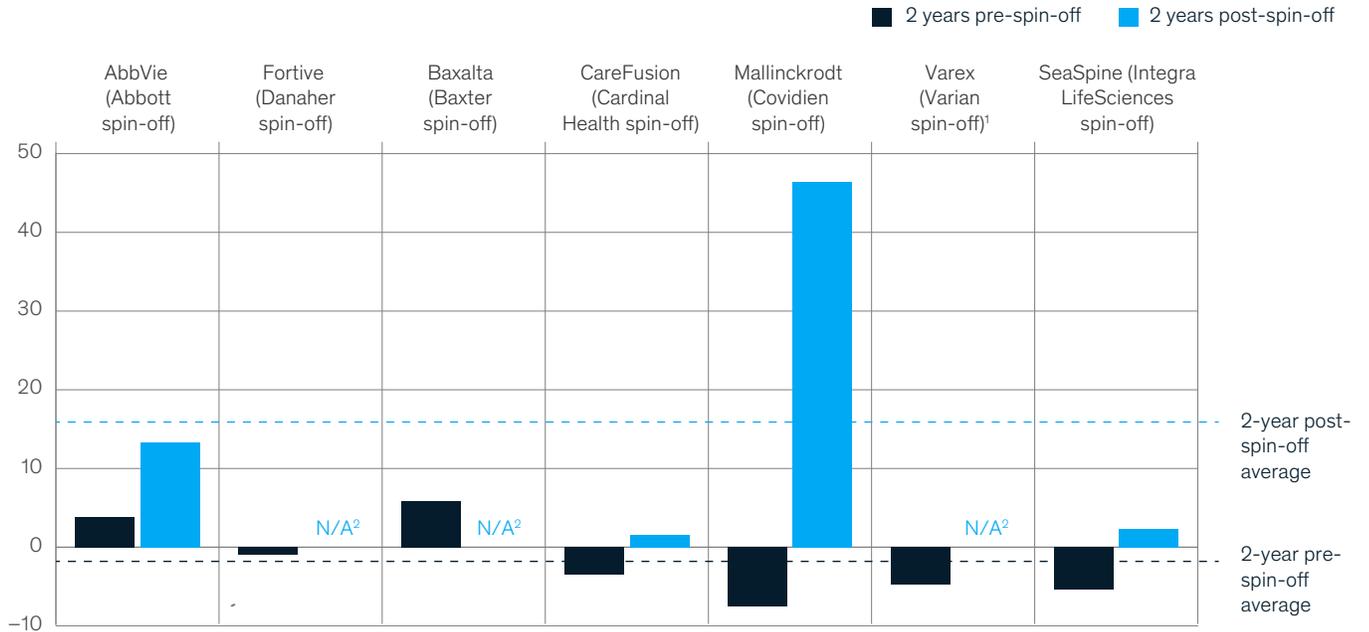
¹ See Lee Dranikoff, Timothy M. Koller, and Antoon Schneider, "Divesting proactively," June 2002, McKinsey.com, and Jay P. Brandimarte, William C. Fallon, and Robert S. McNish, "Trading the corporate portfolio," *McKinsey on Finance*, Autumn 2001, McKinsey.com.

² Data were not available for transactions in 2015 and later; the growth rate quoted includes acquisitions.

Exhibit 3

Growth rates of spun-off medtech businesses increase two years after spin-off.

Spin-off company's average annual growth rate, %



¹Varex Imaging (Varian Medical Systems spin-off).

²Data not available for spin-offs with <2 years of financial data after transaction completion.

Source: Company financial reports; McKinsey analysis

to get right. One is to understand trends in clinical outcomes and potential equivalence between competing products—that is, assessing when the demonstrated clinical benefit of individual products has become equivalent across brands. This signals the potential of a clinical paradigm in which products become “good enough.” It creates potential for pricing pressure to increase as competition shifts to price versus clinical differentiation, and continued growth becomes more challenging as clinical practice largely incorporates the use of the product. This shift could signal a fundamental change in growth outlook that would merit serious consideration of a divestiture.

Another trend medtech companies need to understand is declining reimbursement for relevant procedures. Many healthcare payers around the world are implementing cost controls across the board, but specific categories may be disproportionately affected by reimbursement cuts. In the United States, for instance, drug-coated-balloon angioplasties have been reimbursed by Medicare at the same rate as those performed with standard percutaneous-transluminal-angioplasty (PTA) balloons since January 2018. Companies need to keep on top of their customers’ economics and monitor how hospitals and health systems are reacting to pricing pressure on medical technology.

Other areas in which vigilance is needed include market entry of low-cost companies offering competitive alternative products, particularly in cases with little clinical preference for a given product. Shifts in hospitals' contracting and purchasing patterns are another key factor, especially when they are working to increase adherence to procurement contracts, stipulate the use of standard price formularies, or purchase from a smaller list of preferred vendors. In some markets, it is also important to understand physician-employment trends and their impact on alignment with health systems and thus device-formulary decisions.

A robust and objective portfolio-management process

Successful companies evaluate the factors described above as part of a regular process in which they consider both natural ownership and the potential for value creation for all their assets. This is in keeping with the agile portfolio-management approach to resource reallocation. Value-creation potential is assessed as a function of future market-segment attractiveness (which will depend on, in addition to procedure-volume trends, the reimbursement and commoditization trends described earlier). Natural ownership assesses if the company is best positioned to create value from the business. It includes operational synergies, economies of scale, and corporate value add—for instance, how the company builds up or takes advantage of existing assets (such as manufacturing footprint and contract-manufacturer relationships), the measure of alignment with the company's strategy, regulatory expertise, brand relationships, channel access, sales-force depth and breadth, and management experience.

The most successful divestors codify this into a quantitative rubric and regularly assess all their businesses against it on a semiannual basis or in response to key industry actions (for example, major M&A of competitors and new regulatory requirements). Doing so can counteract the natural reflex by managers to get emotionally attached to businesses they have operated a long time. Acting

with such agility allows for rapid response to market events but requires supporting organizational-agility practices, including empowered teams and action-oriented decision making.

The assessment also should review the feasibility of divesting the business, including the entanglement and ease of separating the business and the ability to execute on the divestment, by either identifying potential buyers or determining the viability of both NewCo and RemainCo as stand-alone entities.

A clear understanding of potential buyers

When a company decides to divest, the number of natural owners in medtech that could justify an acquisition premium is usually quite small. Evaluating the set of potential buyers in advance will help maximize the value of the asset being divested. Financial buyers make up 20 percent of acquirers of divested medtech assets but account for less than 7 percent of total divestiture deal value, indicating that they tend to win in smaller divestitures. A prospective seller needs a deep understanding of potential buyers and a sharp eye for new entrants that could emerge as potential owners. These might include tech companies moving into the medical arena (for instance, Apple recently launched an electrocardiogram capability on the Apple Watch), medtech companies looking for regional expansion, and vertical integrations between providers and intermediaries (for example, ROi launching the Regard portfolio of private-label medical supplies).

Making an effort to understand a potential buyer's strategy and economics will help ease negotiations and achieve the best price from an asset sale. In gauging the value that could be achieved through divestiture, companies should use public-market valuation and potential stand-alone value as a spin-off as benchmarks.

Divestiture management: Early planning and a clean separation

Careful planning early in the process can help ease the transfer of a business by reducing the cost, complexity, and organizational burden of

executing the separation and speeding up margin improvements for both buyer and seller. For example, if a company acquires a new business but plans to divest part of it later, the company can delay integration and run it using separate duplicate processes that will be easy to isolate during a transaction. Even when the entity to be sold does not come from an acquisition, the divestor can start early by installing separate processes not linked to the rest of its businesses. Such early planning can save millions of dollars that would otherwise be spent on TSAs, as well as cut out years of continuing entanglement for buyer and seller.

The most effective companies articulate and plan a clear strategy for the success of the asset after divestiture. McKinsey research shows

that a divesting company is much more likely to outperform peers in its industry when the divested asset also exceeds industry benchmarks.³ Divestitures should follow standard execution best practices across all industries by defining deal boundaries thoughtfully, communicating clearly to employees and customers, and following through to reduce stranded costs associated with the divested business but not eliminated via the deal.⁴

A company that boldly reshapes its medtech portfolio can create significant value and boost growth. Divestitures are a core tool in this endeavor and should be part of any leader's strategic-planning process.

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³ For more on this topic, see Sean O'Connell, Michael Park, and Jannick Thomsen, "Divestitures: How to invest for success," August 2015, McKinsey.com.

⁴ See David Fubini, Michael Park, and Kim Thomas, "Profitably parting ways: Getting more value from divestitures," February 2013, McKinsey.com.