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How Much is My Company Worth?
The Strategic Buyer's Perspective of Value.

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SUMMARY

Understanding value from the perspective of a Medtech Buyer can be a significant benefit to a Target.. A Target should understand:

- The most common approaches to determining value for a Buyer.
- Key variables and assumptions
- Where a Buyer may perceive risk and adjust their valuation
- How to mimic a Buyer's valuation model to enhance the Target's negotiating position.

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How Much Is My Company Worth? The Strategic Buyer's Perspective of Value

I recently completed a buy-side engagement for a global medical device company (alas, we determined to not move forward with the acquisition). The Target was an early stage, pre-commercial, medical device company – compelling product, market opportunity, and economic value proposition. Reflecting back on the transaction process, it reinforced the necessity for Targets to have a well-prepared credible analysis and a thoughtful view of their value to provide a basis for negotiations with a sophisticated Buyer.

In many respects, the best basis to understand one's value is to closely assess value from the Buyer's perspective.

So, how does a strategic Buyer determine value? Each Buyer will have a specific set of financial analyses and metrics that are well accepted within their corporate development best practices. However, the core analysis used by most buyers is the discounted cash flow analysis.

Discounted Cash Flow (DCF):

The DCF is the foundation for value and supports the business case for most Buyers. The DCF will incorporate the detailed assumptions agreed to by the entire buy-side team. The Buyer will use a long term DCF (typically 7 to 10 years) to determine at what values an acquisition has a positive net present value and can achieve internal rates of return equal to or above their hurdle rates. Buyers will use a DCF to analyze a potential acquisition from a number of perspectives. The three most fundamental applications are:

Target Stand-alone DCF:

A strategic Buyer will estimate a Target's DCF value on a stand-alone basis. This analysis determines the projected cash flows

DCF -- Key Valuation Approach

DCF is the core to any Buyside valuation.

Buyer will use a DCF to value a number of scenarios, including:

- Value of Target's stand along business.
- Value of potential synergies
- Pro forma value of an acquisition

Buyers will also use a DCF to value other cash flow streams, such as:

- Value lost of cannibalized products, if any
- Value of losing and not proceeding with a transaction
- Value of alternative strategies.

and discounted value of a Target before any added value/synergies that the Buyer brings to a transaction (e.g. how much is the Target worth without the Buyer). While Targets will often provide their projections to a Buyer as part of due diligence, a Buyer will typically reforecast the projections based on their own assessment of the financial potential of the stand-alone business.

Synergy Analysis.

A Buyer will assess the revenue and expense synergies associated with a transaction. The most readily identifiable synergies will include reductions in G&A costs, eliminating overlapping sales and marketing costs, terminating lease/facility costs, perhaps reducing COGS through in house-manufacturing efficiency, etc. In addition to these more easily realizable synergies, a Buyer will look at the harder to achieve, or riskier, synergies, such as increased sales through a larger sales infrastructure, broader access to accounts, penetrating international markets, product bundling, etc... Lastly, and frankly not often highly valued, are other sources of value, including any complementary product pull-through, future revenues of developing early stage product pipeline, future indications/markets, etc. Buyers often assign limited value to these pull through and pipeline opportunities.

Pro Forma DCF.

The Pro Forma DCF combines the Stand-Alone DCF plus synergies (or visa versa, the synergy analysis can be the Pro Forma DCF less the Stand Alone DCF). The Pro Forma DCF provides the total estimated value that can be generated to the Buyer through an acquisition.

How to "Mimic" the Pro Forma DCF

Trying to mimic a Buyer's Pro Forma DCF can provide a Target with an excellent perspective of the financial assumptions, model sensitivities, underlying gaps and overall value being

Key Assumptions

When "mimicking" the Buyer's DCF, a Buyer should diligently and objectively analyze the key economic variables, including:

- Well-defined target market.
- Bottoms up unit sales projection
- Conservative COGS improvement
- Allocated cost of sales force and marketing
- Realistic cost of R&D, engineering, quality and regulatory teams
-
- Value of alternative strategies.
- Working capital and other required investment

assessed by a Buyer. However, most Targets significantly overestimate sales and underestimate the costs in a Buyer's forecast and DCF. A few best practices for estimating a Buyer's Pro Forma DCF:

TAM/SAM and SOM. While every seller wears their marketing hat when estimating the potential total available market (TAM), a Buyer principally pays for the Share of Market that they can capture in a well-defined market. A Target should carefully conduct a Total Available Market, Serviceable Available Market (SAM) and Share Of Market (SOM) analysis. Be sure to carefully identify the market and the target patient population – where does the Target's product clearly win? Check projected unit volumes against the share that a Buyer could expect to capture during the forecast period. Also include the effect of competition. If this is an attractive market, competition is likely already in development or not far behind. This will have a meaningful effect on the projections and ultimate value.

US and ROW Markets. Understand the Target product's potential in various markets and understand the Buyer's sales infrastructure. For some markets, OUS sales may be a meaningful, near-term contributor to value. For many products, OUS sales are challenging and uncertain. As such, very little, if any, value will be assigned to the opportunity. If OUS sales are a real opportunity for your product, recognize that the Buyer may heavily leverage distributors OUS. As such, the DCF should assume appropriate distributor discounts and margins. Also, depending on the situation, be sure to reflect OUS pricing as well as warehousing, shipping, and transportation costs, which can be quite material expenses.

Unit volume. Buyer's projected unit volume may not be as much of a hockey stick as Targets often assume. Buyers will be careful to consider unit volume that reflects competitive dynamics and potential challenges for product introductions and

adoption. The first couple of years may be quite close to a Target's stand alone projections. It is a good approach to build the "bottoms up" projected unit volume based on the number of sales people at a Buyer, assumed account coverage per sales person and the number of procedures per account. Also, if possible, stratify the sales force productivity based on account utilization (e.g. A, B, C level accounts). This will provide a more real world approach vs. consistent product utilization across all accounts.

ASP. If your company is pre-commercial, be realistic and have solid diligence behind you to support pricing. A Buyer can be expected to be more cautious than optimistic when it comes to pricing. Assume some level of annual price deterioration (often 1 to 2% per year).

COGS. Be conservative with cost reductions. It is not uncommon that in early stage M&A, a Buyer will assume they continue to use the Target's contract manufacturer until volumes are sufficient to bring the production in house. For the year of manufacturing transfer, include assumptions for tooling and capital expenditures.

Sales costs. Targets often assume that sales costs are a sunk cost for a buyer and will not be included as an expense assumption. However, this is not an accurate assumption for many Buyers. Assuming a new or vastly expanded sales force is not required by the Buyer, the Target should assume a sales commission rate appropriate for the sector. In addition, the model should likely incorporate the salaries, benefits and other costs to support some additional mid-level sales and marketing executives (product manager, marketing director) to manage the new product line, as well as any additional clinical support personnel assigned to the product line. Also, assume a level of sales indirect expenses (travel, meals) per sales person -- perhaps an additional 30 - 50% of the commission rate.

Marketing and Customer Training. Be sure to include the potential marketing, customer training and support costs, such as additional conferences, marketing materials, customer training programs and proctoring programs. There will typically be a higher investment during the first few years of launch followed by some maintenance costs.

R&D, Quality and Regulatory. If applicable, assume full salary, benefits and ancillary costs for an R&D and engineering team. It is unlikely the Buyer has extra engineers just hanging around that can absorb new projects. Quality and regulatory can often leverage current personnel for smaller product lines, but will require additional personnel as the product grows.

G&A and Capital Expenditures. This is often a modest allocation per year. A small percent of sales should be allocated for good measure to reflect the additional legal costs, regulatory costs, communication costs, etc…that are incurred with additional sales.

Working capital. A new product will require working capital. A reasonable assumption is 20% of the change in sales for each year. In addition, include the cost of consigned inventory when consignment is an important factor in the business. Consignment can materially increase the costs to add new customers.

Transaction Costs. These are likely small, but advisors, consultants, accountants, lawyers…it all adds up. Make a fair assumption given the size and complexity of the transaction.

Taxes and NOLs. If it is principally a US product, there will be US taxes. Assume 35% federal taxes and 5% state taxes – adjustments can be made as appropriate. In terms of existing NOLs, these can be a marginally attractive part of the value proposition…however; existing NOLs are often partially or

Terminal Value -- The Major Model Driver

Terminal value will determine the majority of the DCF value

Pro forma DCF should have carefully calculated estimates for the terminal year. How one handles taxes and margins will have a major impact on the overall model.

Be conservative in assumptions for

- growth rate
- perpetuity multiple
- terminal cash flows

completely restricted for use by Buyers. Best to ignore these amounts for now. On the other hand, post-transaction operating losses can be carried forward for 15 years to offset future taxes. These should be used in the model (but not the terminal value calculation, in general). Which brings us to…

Terminal Value. For an early stage acquisition, the terminal value will incorporate the most important assumptions in the model. It is not unusual for the terminal value to represent greater than 70% of the total model value. This is because free cash flows are often negative or fairly negligible in the early years of the model. As the terminal year should have a steady state cash flow, it is best to use a discount rate less growth rate approach or an LTM EBITDA multiple (in contrast to a sale multiple). Either approach should result in about the same terminal value. Overall, publicly disclosed fairness opinions for medtech M&A typically use EBITDA multiples somewhere in the 10 – 14x LTM EBITDA range. However, for slow growth products, niche markets or lower margin products, the EBITDA terminal multiples could certainly be lower than this range.

Discount Rate. Use a discount rate that reflects the average cost of capital for your stage of company – not for the buyer as a whole. This can typically be calculated using publicly available information. It is appropriate to use the higher range of a WACC calculation and add on a point or two for unseen and inherent risk. Even at today's low interest rates, a WACC somewhere in the range of 10 to even 15% is fairly common for an early stage, higher risk Target. The WACC will be lower (7 – 11%) for larger scale, commercial Targets.

Base Case vs. Downside Case. Time to risk adjust the model. Once you have developed the DCF, list the highest operating risks that should be a concern of the buyer (customer adoption, product utilization rate, ASP, COGS, market share…). A Target should put together sensitivity analyses around these key

variables (Excel data tables are a terrific means to run these sensitivity analyses without creating new models). These can represent the downside cases. Overall, I would not spend too much time on upside cases. Based on my experience, a Target's "conservative" base case assumptions are typically more optimistic than the Buyer's assumptions (if you weren't overly optimistic by nature, you wouldn't be an entrepreneur!). However, there may be certain scenarios that are worth conducting, even if just to have the cases available for your negotiations with the Buyer.

Sanity Check Your Results. Compare your calculated margins, growth rates and market penetration (in particular your terminal year financial results) to relevant publicly traded companies, market research and industry peers. Are there precedents to your level of sales growth, adoption ramp, operating margins and expense levels as a percent of sales? The sanity check ensures that you have well grounded support for the final results.

Other Analysis Used by Buyers

In addition to the DCF analysis, Buyers will use other analysis to support their valuation or assess associated risks of the transaction. Without spending too much time on the components of the analyses, common supporting analyses include:

Return on Invested Capital. While the DCF will utilize a cost of capital (and often a somewhat risk adjusted cost of capital for many Buyers), the ROIC will show the actual return expected at any given level of purchase price. Buyers will look at both the overall ROIC as well as how ROIC improves after each projected year. For any Buyer, the goal is to generate a return in excess of your minimum cost of capital or hurdle rate requirement.

Other Approaches Besides the DCF

Buyers will use other important analysis aside from the DCF to assess a transaction, including:

- Return on Invested Capital
- Discounted Pay Back Analysis
- Pro Forma Financial Analysis
- Accretion / Dilution Analysis
- Review of Precedent Transactions

Discounted Pay Back Analysis. An interesting analysis, for early stage acquisitions in particular, the DPBA shows how long it takes for an acquisition to repay the invested capital. The analysis can be quite informative in situations where there is a positive DCF value but the majority of the value is generated near the end, or in the terminal year, of a DCF. Buyers will often be more risk adverse where the cash flow is not achievable until the latter years of the projection.

Pro Forma Analysis. As part of the DCF, the Buyer will typically assess how the acquisition changes the profile of the total business. Key metrics typically include total size of sales, sales growth rate, sales composition within a particular sector, change in gross margin, EBITDA margin, EBIT margin and net income/EPS. Depending on the Buyer and the scale of the transaction, the Pro Forma analysis will also incorporate a balance sheet analysis to assess effect on overall leverage, compliance with debt covenants, liquidity and working capital ratios.

Accretion/Dilution Analysis. A public company will look at the accounting effect of a transaction on EPS and how the transaction will increase or decrease their projected EPS against internal and analyst estimates. Transactions need to be structured in order to be accretive to EPS and a division's operating results within a reasonable time frame.

Precedent Transactions and Public Comps. Buyers will certainly include transaction comps for other comparable deals in their analysis. However, for the more sophisticated Buyers, precedent transaction and public comparables principally provide a sanity check against the DCF results rather than provide a real foundation for the value of a deal.

Conclusion

The Pro Forma DCF provides the Target with a rigorously calculated view of value from a Buyer.

Target can understand the greatest areas of risk and the impact on value.

DCF can be leveraged to better understand areas of risk, address Buyer's concerns and maximize the negotiated value of a Transaction.

You Completed the Pro Forma DCF…Now What?

Once you are comfortable with the DCF analysis…now what? What does this tell you?

The stand-alone DCF tells you exactly that – the value of a Target on a stand-alone basis. The Pro Forma DCF provides the total value up to which a Buyer could pay at their cost of capital. In reality, a Buyer will look to pay somewhere between the two values. In medtech M&A, Buyers will share a portion of the "synergy value" – the difference between the Pro Forma and the Stand Alone DCF – in order to win a deal. A Buyer will be more willing to share the value of the less risky synergies (e.g. expense reductions, lower level sales improvement) than the higher risk synergies (e.g. higher end of sales volume, pipeline products, OUS expansion). It would not be unusual for a strategic to share up to 50% (or perhaps more) of the total synergy value in the case of a highly strategic transaction with high confidence in achieving the synergy levels. However, in riskier transactions, the transaction value will increasingly approach the stand- alone Target value (too much risk to achieve projected synergies). The question is how much of these synergies will be shared – and that is part of the sale process and the ultimate price negotiation.

The DCF analysis base case provides a Target with their own sense of how a strategic is viewing value, what value a Buyer brings to the table and what portion of projected Pro Forma DCF value the Target has captured in the negotiation. This enables the Target to improve their negotiating questions, focus on key operating risks in order to mitigate a Buyer's concerns and maximize the value of the transaction.

Conclusion

In summary, a Buyer will go through a disciplined approach to develop financial projections and models that objectively

A Target Cannot Be Over-prepared

A sale transaction requires an immense investment of time and resources.

Preparation is key to ensure a smooth, successful and value-maximizing transaction.

Leverage your board, investors, advisors and counsels to ensure that you have the best information and resources to conduct a transaction.

calculate the value of a transaction. While it is very difficult for a Target to truly mimic the projections and DCF value of a Buyer, a Target can construct a well-supported financial model that incorporates reasonable Buyer-minded assumptions. Once armed with this model, a Target will improve their negotiating position by better understanding the Buyer's perspective of opportunities, risks and ultimately valuation.

As With Everything, Preparation is Key!

Running a successful sale process is a major undertaking. The process will be significantly enhanced through highly focused planning and preparation. The process can be overwhelming for many small companies while they work full time to achieve operating milestones and deliver on the hyper-growth expectations of their investors. In contrast, Buyers have full-time teams who are dedicated to conducting these transactions. To be well prepared, a Target should assemble a team of experienced advisors, counsels, consultants, etc… and leverage their years of experience to maximize the preparation, execution, value and success of your future transaction.

RIM Advisors

RIM Advisors provides strategic advisory services to high growth companies in the medical technology and life sciences sectors. Founded in 2008, the firm provides a range of services to its clients, including strategic sale and buy-side advisory, corporate partnering, strategic planning, in-depth assessment of product market opportunity and other strategic advisory services.

RIM Advisors offers senior level experience and a service level that is unique to today's marketplace. Based on two decades of experience in investment banking and advisory services by the principal and founder, Richard Innenberg, the firm reflects its expertise through a significant portfolio of strategic relationships and industry partnerships.

Richard brings a strong and expansive breadth of services having previously served over 100 healthcare, medical technology and growth companies through a broad range of investment banking and corporate development transactions. Specific activities include: exclusive sale transactions, buy-side transactions, division buyouts, corporate partnering, private and public financing, liquidations and corporate restructuring.

Richard is also a Managing Director with New Century Capital Partners Inc., a member of FINRA and SIPC.

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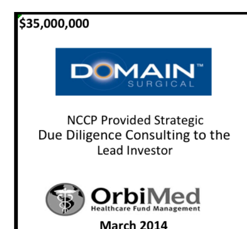
PROJECT ENT

NCCP Provided Exclusive Strategic Buyside Advisory Services to A Global Medical Device Company

Major Global Medical Technology Client

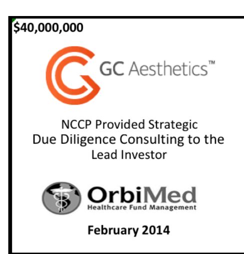
September 2014



PROJECT ROBOT

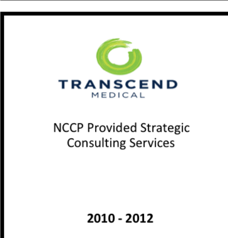
NCCP Provided Strategic Due Diligence Consulting to a Potential Investor

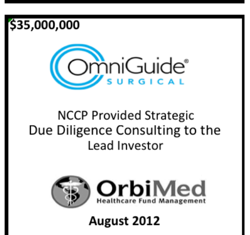
March 2014

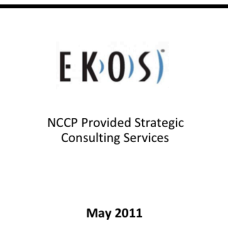


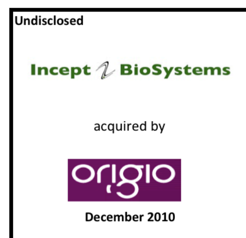
NCCP Provided Strategic and Financing Process Advisory Services

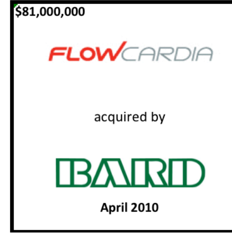
September 2013

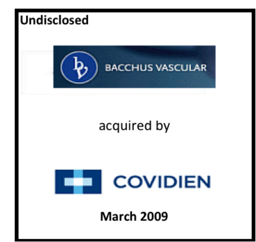












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