M&A in Medtech

Restarting the Engine
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M&A in Medtech

Restarting the Engine

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After years of high growth and generous margins, the medical-technology (medtech) industry is entering leaner times. Companies will look to mergers and acquisitions to respond to a lower growth outlook, price and profitability pressures, and innovation difficulties.

**Systematically Search for Targets**
Medtech companies must compete for M&A opportunities against pharmaceutical and electrical companies as well as financial investors. As a result, competition and prices for attractive targets will continue to rise. Successful dealmaking depends on systematic screening and diligent evaluation, especially for acquirers seeking to bolster R&D or enter emerging markets.

**Plan Ahead for Integration**
Making medtech deals work is especially challenging. The innovation-driven cultures of many potential targets may not integrate easily into companies that stress sales growth and cost control. What’s more, emerging-market M&A poses its own unique challenges. To realize value, acquirers need a clear understanding of strategic and operational fit and a detailed integration plan.

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**AT A GLANCE**
**Ducunt fata volentem, nolentem trahunt.**
*(Fate leads the willing, but drags the unwilling.)*
— Seneca

After years of stellar financial performance, the medical-technology (medtech) industry is cooling off and bracing for a future of falling prices, slower revenue growth, and slimmer profit margins. The structural challenges facing the industry are serious and not easily resolved. Health care providers are putting pressure on prices and demanding firmer proof that medtech products are worth their money. The number of innovative products brought to market is declining, and regulatory approval for new products is becoming more difficult—especially in the U.S. but increasingly so in Europe as well. What’s more, the rewards for incremental innovation, which used to be the recipe for success in the sector, are dwindling. Sales growth in the developed Western economies, which still account for 80 percent of industry revenue, has flattened out at levels similar to overall health-care growth. Growth in emerging economies is soaring, but most medtech companies lack the capabilities needed to penetrate those markets. (See *The Future of Medtech*, a BCG report to be published in IN VIVO, Fall 2012.)

As the medtech industry reshapes itself, mergers and acquisitions will likely be an important tool, because savvy dealmaking enables companies to adapt to a changing competitive environment more quickly than making organic moves. The right deals will allow medtech companies to leverage customer and market access through consolidation, to strategically expand their product portfolios, to bolster R&D pipelines, and to secure strategic footholds in emerging markets.

But success in medtech M&A is hard-won. In the Western world, medtech is typically characterized more often by a focus on innovation and managing growth than on cost control, which we believe will play an important role in extracting value from future medtech M&A. In addition, many small companies have relatively little experience in M&A. They also compete in a bewildering diversity of niches, and integrating different business models and innovation cultures into larger organizations with different strategic objectives can be difficult.

Competition for attractive medtech targets, moreover, is likely to be intense. Not only must medtech companies contend with the competition but they also often have to bid against private-equity firms, pharmaceutical companies, and (mostly Asian) electronics-equipment manufacturers entering attractive medtech segments or leveraging their core competencies in therapeutic areas or manufacturing...
know-how. At the same time, a decline in venture capital funding for medtech start-ups means that there are fewer new targets on the market in the medium term. Consequently, while stock market valuations have come down, deal premiums for attractive assets are likely to rise.

In this competitive environment, the advantage goes to acquirers that can generate meaningful synergies or deliver significant operational improvements. Diligent execution and attention to detail will become increasingly crucial in order to ensure that M&A deals in medtech create rather than destroy value. Finding the right deal at the right price—and having the ability to evaluate probabilities of success as regulatory risks rise—will become more difficult and decisive. Attention to detail in medtech M&A will enable companies to restart their engines and strengthen their competitive advantage.

Rough Landing for a Highflier

For much of the past decade, the medtech industry has been a highflier. This diverse sector—which includes hospital equipment, in vitro diagnostics, devices such as pacemakers and drug-eluting stents, and medical supplies such as gloves or infusion sets—brought to market innovative products that filled previously unmet patient needs. Over the past decade, overall revenues in the industry grew by an average of 9 percent a year, and earnings before interest and taxes (EBIT) grew by around 12 percent.

Momentum has slowed considerably, however. Coming back from the financial crisis of 2008 and 2009, sales growth for large medtech companies has slipped to around 5 percent a year, a pace that is unlikely to improve in the next few years. (See Exhibit 1.) EBIT margins for the industry as a whole are projected to decrease by around 2 percent over the next decade, although wide variations will result given the diversity of subsegments. (See The Future of Medtech, forthcoming in IN VIVO, Fall 2012.) Dampered performance is also reflected in the sector’s total shareholder return, which, as detailed in our recent Value Creators report, has plunged from 9 percent per year from 2002 through 2006 to only 3 percent per year from 2007 through 2010. (See The 2011 Health Care Value Creators Report: How Can Health Care Companies Create More Value? BCG report, January 2012.)

The cloudy outlook for medtech also reflects to some extent the macroeconomic uncertainties—such as financial market volatility and low earnings visibility—that many industries face today. (See M&A: Using Uncertainty to Your Advantage; A Survey of European Companies’ Merger and Acquisition Plans for 2012, BCG Focus, December 2011.) In addition, medtech companies face three industry-specific structural challenges: mounting price pressures in the West as health care providers clamp down on costs, a sputtering innovation engine, and the limited ability of many Western medtech companies to tap the immense growth potential of emerging markets.

Mounting Price Pressures

Prices of medtech products are expected to decline on average by 2 percent a year over the next decade. In response to cost pressures, hospitals are further profession-
alizing the purchasing process, exercising rigorous cost control over not just commodities such as medical supplies but also higher-end physician-preference items. As a result, the “good old days,” when physicians typically selected medical devices with little interference from those paying the bills, are coming to an end.

Professional purchasing introduces cost-benefit tradeoffs. Purchasing functions now establish systematic sourcing criteria, compare quotes from different medtech vendors, and pay higher prices only for products proved to perform better than cheaper alternatives. Medtech providers have come to expect purchasing executives to assess financial data comprehensively, looking beyond the one-time purchase price to process costs and additional revenues from attracting new patients and doctors. Gain-sharing agreements, which align the interests of vendors and physicians by tying payments to the patient benefit delivered by medtech devices, are also growing. Other mechanisms for price control include cap pricing, profitability tracking, restrictions of premium products to specific patients, and limits on the number of vendors in order to increase bargaining power.

This trend is accelerating as hospitals, physicians’ practices, and other health-care providers consolidate, placing more purchasing power in the hands of fewer specialists. In health care systems such as those in the U.S., Italy, and France—where purchasing decisions used to be left to local hospitals and procurement managers—centralized decision making is coming to the fore. At the same time, low-cost, low-price competitors from emerging markets are increasing their penetration of Western markets. Device registrations in classes I, II, and III have doubled from 2000 through 2010, and the trend is expected to continue.
These price pressures have put the brakes on growth and margins. Companies find it especially difficult to charge high premiums for products that offer only incremental innovation. In the first decade of the twenty-first century, around 50 to 70 percent of U.S. revenue growth derived from increasing prices and the shift to higher-priced products. Today, growth must come from other, more complex sources.

The environment of declining price premiums is driving a change in strategic focus. Rather than relying on incremental innovation, sales growth, and customer loyalty, the industry is turning its attention to cost control, introducing more sophisticated pricing strategies, and adapting sales forces to deal with the new powers in the purchasing office. Companies are attending more closely to R&D efficiency and emphasizing low-cost sourcing and production, deploying best practices in operational excellence from other industries. Segment consolidation through M&A can allow cost-conscious companies to increase revenues from existing products, despite declining prices, by leveraging customer relationships and geographic footprint. Consolidation plays are also valuable tools for eliminating overhead and sales force costs.

**The Sputtering Innovation Engine**

Innovation by medtech companies has declined sharply over the past decade, according to regulatory data. There has been a steep drop in original premarket approvals (PMAs) by the U.S. Food and Drug Administration for pioneering breakthroughs. There also has been a falloff in the FDA's 510(k) notifications, filed for incremental innovation or “me-too” products. (See Exhibit 2.)

**EXHIBIT 2 | Large Medtechs Defy the Trend of Declining Innovation**

![Graph showing the trend of declining innovation](graph)

**Sources:** FDA PMA approval database; FDA 510(k) premarket notification database; Orbis database; BCG analysis.

**Note:** Approvals are categorized by year of decision.

1Some PMA originals are not classified because of a lack of company information.
Tightening regulation and greater difficulty securing regulatory approvals for new products are among the key reasons behind slowing innovation rates. Compounding the challenges, U.S. legislators are discussing a further tightening of the FDA’s approval processes. Several medtech companies have already responded by commercializing new products first in Europe, bypassing U.S. regulators.

An uptick in PMAs over the past two years is cause for tempered optimism. But the growth in approvals is coming solely from companies with annual sales of $5 billion or more, suggesting that the regulatory cost and risk of innovation has become an unsustainable burden for many small and medium-size companies. Instead, innovation is increasingly concentrated among large companies that can more easily afford the expense and uncertainty of the PMA process.

The same conditions are constraining the growth of new entrants to the industry. Venture capital firms show declining interest in funding early-stage medtech R&D, deterred by the lengthy approval process and their own diminished appetites for risk. (See Exhibit 3.) The decline in funding is translating into fewer medtech start-ups. Curtailed start-up activity limits the population of potential takeover targets, weakening the external R&D pipeline. Does this forebode a further decline in innovative new products?

Not necessarily. But to power future growth, large medtech companies will have to reboot the R&D engine. And given the shrinking rewards for incremental improvements, companies have little choice but to seek breakthrough innovations if they want to sustain high-price premiums and margins. Internal improvements alone are

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**EXHIBIT 3 | Will Fewer Medtech Start-Ups Weaken the External R&D Pipeline?**

**Venture capital funding is falling because of high capital-market and regulatory risks...**

Global venture-capital investments in medtech ($billions)

<table>
<thead>
<tr>
<th>Year</th>
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<td>2.8</td>
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<td>2.5</td>
<td>3.3</td>
<td>4.1</td>
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<td>5.2</td>
<td>4.0</td>
<td>3.6</td>
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**...resulting in a smaller pool of innovative medtech start-ups**

Number of new medtech start-ups

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<th>Year</th>
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<td>160</td>
<td>103</td>
<td>86</td>
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</tr>
</tbody>
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Sources: Thomson Reuters; Ernst & Young medical technology report, 2011; MedMarket Diligence; BCG analysis.
unlikely to get the job done. To complement internal efforts with outside, possibly more disruptive ideas and to diversify pipeline risk, companies need to consider acquiring external R&D via M&A.

**Limited Emerging-Market Capabilities**

Eighty percent of medical technology sales are in developed markets such as the U.S., the European Union, and Japan—with the U.S. alone accounting for half those revenues. Growth in these markets is slowing, however, while volume in emerging markets is growing at a record annual pace of 10 percent—twice that of industrialized nations. This increase is driven by population growth, rising wealth, improvements in health care systems, and a rising incidence of “lifestyle” diseases such as diabetes. This two-speed world—relatively stagnant industrialized nations on the one hand and rapidly growing economies such as those of China, India, and Brazil on the other—all but compels companies to build a strong footprint in the emerging markets.

Success in such markets, however, requires new capabilities. Because health care budgets are lower in emerging markets, companies must be able to develop and market medtech products at substantially lower price points. Stripped-down versions of products for developed markets rarely catch on commercially. In their place, companies need to build portfolios of more basic products customized for emerging markets, where rickety transportation infrastructures, unreliable power supplies, and the lack of trained service technicians are facts of life. (See “China’s Health Care Reform: Bull Run for Medtech Starts in the Year of the Ox,” BCG article, November 2009.)

Not only do many Western medtech companies lack such know-how but they also face strong competition from aggressive, fast-evolving local companies. In China, where the government has targeted medical technology as a key focus of industrial policy, multinationals have lost around 30 percent of market share to local competitors in the past five years. In the market for magnetic resonance tomography products, for example, 15 Chinese companies have sprung up in the past two years alone. In some emerging markets, local competitors undercut costs and prices of multinationals by around half.

To participate in the growth of those markets, it is crucial that Western medtech companies obtain local production facilities, local market knowledge and access, and the ability to tailor products to specific local demands. M&A, as well as joint ventures, can help companies build these capabilities quickly and efficiently.

**Medtech’s M&A Motives**

Over the past few years, we have seen medtech companies use M&A to achieve a broad spectrum of strategic imperatives, including sector consolidation, product portfolio expansion, and R&D access. Five major rationales, singly or in some combination, drove M&A deals in medtech with transaction values greater than $1 billion, according to our analysis of all such deals in the past five years. (See Exhibit 4.)
Market Segment Consolidation. The majority of large medtech deals—almost 75 percent—were aimed at increasing presence in specific market segments through consolidation. Companies strived to make use of customer relationships and complementary geographic sales footprints to increase revenues of combined product portfolios in a specific therapeutic area. One example of this strategy at work is at Fresenius, a company that has transformed itself into a dialysis giant through a series of acquisitions, the most recent being its 2011 purchase of Hema Metrics. Similarly, Johnson & Johnson developed a stronger and more comprehensive position in orthopedics last year by acquiring Synthes.

Strategic Portfolio Extension. The second dominant motive of medtech M&A deals, found in 61 percent of those we studied, is to broaden a company’s product portfolio. The first stage of such a strategy is to expand the existing product offerings by adding complementary services or software. This is visible in the medical-device business, for example, as dental-implant companies have acquired the computer-aided design and manufacturing software that allows the dental lab to design prosthetics individualized for each patient. We expect this trend to continue as the growing importance of information drives the shift from hardware to software.

The medical-treatment process, which demands comprehensive data generation, storage, and analysis, is driving other moves into software. The large number of IT start-ups developing software and mobile devices for health care applications illustrates the growing prominence of this trend.

The second stage of strategic portfolio expansion is the construction of integrated business models, in some cases allowing medtech companies to offer products and services as a single connected entity.
services across the full value chain in fields such as care management. In these cases, companies do not merely offer discrete products and services but instead control the entire care-management process. Such a strategy can enable companies to leverage their sales forces, buyer relationships, and understanding of patient needs. One example of such integration is Siemens’ drive into breast cancer therapy. Siemens has been buying companies that cover the entire value chain—from breast cancer diagnosis and data collection through analysis and therapy.

**Access to R&D/Technology.** Acquiring an R&D pipeline to complement organic innovation efforts continues to be a leading objective, driving 30 percent of the deals studied. Such deals are symbiotic partnerships: big medtech companies buy into small, innovative, and entrepreneurial ones for their R&D and to diversify their in-house research. Smaller companies profit from the acquirer’s funding, marketing know-how, and manufacturing and distribution capabilities. Both sides gain from the arrangement.

**Strategic Entry by Nonmedtech Players.** Companies outside of the industry are also buying into the medtech sector. Twenty-five percent of the deals analyzed involved private-equity firms, which were attracted by solid growth, high margins, and good opportunities to exit through IPOs or by selling companies to strategic players. Apax and several large pension funds, for example, bought Kinetic Concepts, a maker of surgical and medical instruments and apparatus, in a $5.8 billion leveraged buyout in July 2011. Because most medtech companies did not have to focus on being lean and mean in the past, there are substantial opportunities for private-equity firms to create value through operational improvements.

Fourteen percent of the M&A deals analyzed involved companies without an existing medtech business (such as pharma and electronics companies) diversifying into adjacent medtech. Such deals represent pharma companies’ attempt to counter the challenges in their own industry—such as the looming expiration of patents for branded blockbuster drugs—without massively diluting their margins. At the same time, the deals try to leverage the pharmaceutical companies’ access to customers or to offer integrated medtech-pharmaceutical products.

Asian information-technology and equipment companies are also expanding into medtech. Hitachi is already active in medical equipment. Samsung publicly announced last year that it aspires to become one of the world’s largest medical-imaging companies and has put aside $1.1 billion for acquisitions. Sony recently bought Micronics to enter the portable-medical-testing segment and announced plans to make more acquisitions. Such companies can leverage their expertise in low-cost, high-reliability electronics manufacturing to create synergies and cater to emerging markets where purchasing and maintenance budgets are limited.

**Penetrating Emerging Markets.** While establishing a presence in emerging markets has not been a prime rationale for medtech M&A previously, its importance is growing fast. Zimmer’s $50 million purchase of the Chinese orthopedics company Beijing Montagne Medical in 2010 exemplifies this interest. Inverness Med Innovations, Hologic, and Medtronic have also acquired stakes in Chinese companies. Barriers to emerging-market acquisitions, however, are high. Attractive
targets are scarce, and cross-border integration is a stiff challenge. What’s more, local medtech companies are increasingly confident and have M&A aspirations of their own. Chinese medical-device-maker Mindray, for example, bought 50 percent of Datascope, a U.S. company, for $200 million in 2008.

Executing Medtech M&A: Shifting Gears

Current conditions in the financial and capital markets pose only limited obstacles for M&A in the medtech industry. The past few years showed strong M&A momentum, with the number of European deals hovering consistently at around 60 a quarter before slowing during the generally difficult second half of 2011. (See Exhibit 5.) Private-equity firms have returned to the field, armed with substantial amounts of bank financing, as exemplified by Blackstone’s astonishing $16 billion bid for Synthes in mid-2011. (Ultimately, Johnson & Johnson made off with the prize.) Since then, amid concerns over the euro crisis and slowing global growth, banks have again significantly tightened their financing commitments. Yet even that development has its upside, as venture capital and private-equity firms look for ways to exit previous investments in medtech, fueling the deal pipeline. Many large medtech companies have cash at the ready to pounce on such deals, having taken advantage of low interest rates to issue debt.

The recent decline in stock prices has reduced the valuations of medtech companies to attractive levels. Heightened interest by private-equity, pharmaceutical, and electronics companies, however, could again drive up prices of attractive targets, especially medtech companies that are large enough to achieve significant scale but small enough to make acquisition financing easy.

**EXHIBIT 5 | The Number of Medtech M&A Deals Remains Consistently High**

The value and number of announced worldwide M&A transactions in medtech

Transaction volume ($billions) Number of transactions


Number of transactions

Large deals = $1 billion or more

Sources: Thomson ONE; BCG analysis.

Note: Chart includes announced medtech M&A deals globally from March 1, 2000–June 30, 2012.
In the face of increased uncertainty about the industry’s outlook and the financial markets, shifting into the right gears becomes more important. Solid strategic insights into the industry and thorough functional expertise in M&A are required. We put forward four key considerations that could differentiate the wheat from the chaff when doing medtech M&A.

**Clarify deal rationales.** Both achieving growth and cutting costs through medtech M&A are easier said than done. To achieve the sought-after objectives, companies must clearly understand how a targeted business relates to their existing operations. In an industry as fragmented as medtech, several good opportunities may seem to exist. But to use their capital efficiently and build value, acquirers must clearly identify the synergies between their revenue and cost structures and those of their targets.

Companies should have a clear plan up front for integrating acquisitions and successfully commercializing technology. To avoid strangling product development, acquirers must carefully gauge the appropriate degree of integration, governance, and control of the acquired company. Operations and sales forces in the combined company often have trouble bringing new technology to market, especially if their cultures and business models differ widely, as often happens with medtech hardware and software companies. The success of development and go-to-market efforts depends on the sound integration of both people and technology.

**Shift the focus to costs.** Many medtech companies do not have cost structures that are sustainable in the medium or long term. The cost of maintaining sales forces, for example, consumes a much higher percentage of revenues in medtech than in comparable industries, leaving lots of headroom for savings. Cost optimization, therefore, must take a more prominent place among the strategic responses to shrinking profit margins. In particular, medium-size medtechs, with fixed costs making up a large portion of total costs, can substantially improve their cost positions by combining internal operational-excellence programs with cost-cutting M&A.

**Place bigger bets on R&D.** As payers and providers professionalize and regulation becomes more sophisticated, me-too products and smaller players will be squeezed out.

Competition and deal premiums for attractive targets are likely to rise. All medtech companies will hunt for promising M&A candidates as their own innovation challenges mount. Just as the number of bidders increases, meanwhile, there will be fewer start-ups if the supply of early-stage financing remains tight.

Finding the right target at the right price is likely to become a key source of competitive advantage. Medtech companies should assign specialists using best practices to screen and evaluate targets and systematically tap their R&D and sales.
departments for insights that can translate into improved deal sourcing and target selection. As regulatory risks rise, acquirers must carefully evaluate the probabilities of success to avoid overpaying.

**Deploy significant resources to emerging-market deals.** Most Western medtech companies have limited in-house skills needed to succeed in emerging markets. To compensate for their lack of know-how, prospective acquirers should consider joint ventures as well as deals specifically intended to acquire local knowledge and contacts. Finding the right target, however, demands serious time and effort.

Conditions on the ground change constantly, and the sheer size and diversity of the market can be mind-boggling. In China, for example, producers of x-ray equipment must choose from several thousand distributors of such equipment. Because success in emerging markets relies on market access and rapid knowledge acquisition, companies must strike the right balance between fast action and thorough diligence. Navigating this unfamiliar and often treacherous terrain will require substantially more resources than Western M&A demands. Acquirers in emerging markets must also be proactive, dependent on the deal structure and deal motives, and ready to include patent protection to prevent losses of intellectual property. In

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**THE STRYKER-BOSTON SCIENTIFIC M&A DEAL**

In a deal closed in January 2011, BCG advised Stryker on its acquisition of Boston Scientific’s neurovascular business, which sells devices such as stents and microcatheters. Stryker paid $1.4 billion in cash up front and $100 million contingent on the development of a device for stroke victims and on the transfer of manufacturing plants. The consolidating move positioned Stryker as a global leader in a high-growth segment of the medical-technology market.

BCG provided end-to-end buy-side support to Stryker, combining strategic industry insight with M&A transaction expertise. BCG’s support included the following:

- Creating a market model to evaluate market attractiveness
- Creating a business plan model to determine the asset value of the business unit
- Supporting the transaction office
- Supporting the regulatory review with market share and competition analysis
- Negotiating the transaction service agreement to ensure uninterrupted business throughout the transition period
- Developing a long-term integration plan and assembling the integration team to ensure day-one postmerger-integration readiness

The deal received positive feedback from the analyst community. Since the deal was announced, Stryker’s shares have outperformed the sector index by more than 5 percentage points, as of mid-May 2012.
China, especially, extraction of intellectual property is a declared strategy of state-backed domestic medtech companies.

In the face of substantial industry challenges, the strategic focus for medtech companies must shift from organizing growth to pursuing more systematic innovation, geographic expansion, and cost management. M&A will be an essential tool to improve competitive positions quickly and substantially. At the same time, intensifying competition for targets and the idiosyncrasies of medtech deals make execution complex. The medtech companies that create value and improve their competitive positions through M&A will be those with clear strategic rationales, a greater appetite for cost synergies, and the willingness to place bigger R&D bets and to deploy significant resources in emerging markets. Restarting the engine requires professional tuning and bold action fueled by a long-term motivating vision.
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For Further Contact

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