Medical equipment loan-to-own deals heat up as venture capital fades – Middle Market Memo
by Jon Berke
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Artificial heart manufacturer **SynCardia Systems'** effort to go public in late 2015 was stymied by the all too common wild card of medical regulatory decrees.

The FDA released information in June 2015 suggesting a higher mortality rate among patients using the company's equipment, and recommended surgeons and cardiologists consider that when making "device selections," according to court filings. SynCardia issued a letter outlining what it saw as inaccuracies in the data. The FDA notice, which was eventually rescinded, first came out prior to SynCardia's IPO road show and negatively impacted the company's ability to tap the equity markets, said a source close to the situation.

With the IPO option off the table, the capital-constrained company wound up filing for bankruptcy on 5 July and accepted a credit bid with affiliates of Versa Capital who had acquired the company's pre-petition bank debt.

SynCardia's story is now becoming the new normal for mid-cap medical equipment companies as the venture capital community has largely turned off the spigot for development, while bigger equipment companies are not prone to dealing with turnaround stories.

The end result is a smattering of companies dependent on turnaround funds and rescue capital in advance of a potential sale to a larger company down the road. And as evidenced by some recent deals, buyers have been willing to pay generous multiples for more mature companies. This includes last year's hotly contested auction for wheelchair equipment manufacturer **Sunrise Medical**, which sold for roughly 10x-12x its EUR 50m EBITDA to Nordic Capital.

"These companies for years had been able to raise an unlimited amount of money from the public and private markets, but that trend has come to a halt and entities need to figure out how to change their business model, stop bleeding money and be able to convince potential investors why they will be the ones who will achieve profitability down the road - and sooner rather than a lot later", said Peter Kaufman, president of New York-based financial restructuring firm Gordian Group, LLC.

Venture capital support for medical devices and equipment peaked in 3Q15 with USD 855m raised across 84 deals, but has since dropped to USD 538m raised in 2Q16 over 61 deals, according to the MoneyTree Inc. report, a joint report published by PriceWaterhouseCoopers and the National Venture Capital Association (NVCA).

On a more granular level, early stage medical device venture capital has still been healthy on some fronts, but later stage venture capital has tailed off. Along with the capital intensive nature of the equipment space, venture capital dollars have also been siphoned off to less costly industries such as software, and flashier areas like biotech, according to Greg Vlahos, a leader of PwC's Life Sciences & Venture Capital Group.

Usually, it takes four to six years for a company to first develop a product, then go through multiple trials with the FDA before it gets approved to hit the market. This is often outside the time horizon for a normal venture capital investment, said one private equity executive.

Companies in nearly every corner of the medical device field have been caught up in the timing trap over the past year, as cost issues contributed to the bankruptcies of not only SynCardia, but cardiology device manufacturer **Cardiac Sciences Corp** and plasma therapy maker **Nuo Therapeutics**.

Loan-to-own funds willing to credit bid ultimately acquired pre-petition debt at a deep discount in both SynCardia and Cardiac Sciences, while Nuo raised a bank loan from an opportunity fund at a high coupon. Aurora Resurgence wound up acquiring Cardiac Science, and Versa Capital has a stalking horse credit bid on the table for SynCardia in advance of next month's auction. Deerfield had been seeking to credit bid for Nuo, but some of the company's shareholders raised USD 7.5m and became majority shareholders, while old equity who didn't participate also wound up with roughly a roughly 25% equity stake under the deal.

"As the firm in our field who is known as the champion of 'old equity' in these tough situations, running a PR effective and competitive process for the needed new capital is paramount to success," said Gordian's Kaufman, who advised Nuo on the deal.

Recently, spinal equipment manufacturer **Alphatec Holdings** had been in default of both of its credit facilities and had waivers through the end of the year, but received a USD 110m bid from fellow strategic **Globus Medical** to acquire its international operations and distribution channels. The bid included USD 80m in cash and a USD 30m 5-year senior secured credit facility to replace its existing term loan with Deerfield Financial.

Deal therapy

The payoff for turnaround funds or private equity funds can be highly lucrative in the medical equipment space as more diversified, cash rich companies are able to fold brands into their roster of products.

For instance, Heartware Medical had a challenging 2015 in which its signature Heartware Ventricular Assist System (HVAD), which provides circulatory support for patients in the advanced stages of heart failure, experienced a slowdown in US volumes. In addition, it had issues developing a next generation device and finally an activist shareholder successfully blocked the company's acquisition of another medical device manufacturer.

Still, British giant **Medtronic plc** acquired the Framingham, Mass-based Heartware for USD 1.1bn in June. Heartware had negative EBITDA in 2015, but Medtronic was primarily interested in growing the company's roster of devices.

"It's a familiar refrain in the medical device business, they are a builder of businesses, not fixers," said one industry source.