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Should Medical Device Companies Make or Buy Their Growth?

Companies investing in R&D have created more value for shareholders over the past 10 years.

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In most industries, the greater the proportion of cash flow that companies reinvest back into the future of their business, the higher their share price tends to rise over time. Not so for medical-device companies in recent years, especially when that reinvestment is into acquisitions.

These findings were deduced from our study of the relationship between total shareholder return (dividends and share-price appreciation) and capital deployment practices. We looked at the 30 largest U.S. medical-device companies in terms of their current market capitalization that were publicly traded from 2002 through 2011 and examined this relationship during two separate periods, 2002 through 2006 and 2007 through 2011.

From 2002 through 2006, aging populations in the United States and many developed nations fueled health-care demand while such innovative companies as St. Jude, Becton Dickinson, and Intuitive Surgical expanded the supply of services and equipment by launching new devices and treatments for illnesses and injuries that previously went untreated. The industry included many “Wall Street Darlings” during this stretch, as more than half the medical-device companies delivered more than twice the total shareholder return (TSR) of the S&P 500.

Those that reinvested an above-average proportion of their cash earnings back into the business during this period delivered 9% higher TSR on average than those that reinvested less. In contrast, those that deployed an above-average amount of their cash earnings to repurchase shares delivered 7% lower TSR than those that repurchased little or no shares.

The type of reinvestment matters significantly. Interestingly, those that stressed research and development (R&D) investment outperformed their peers’ TSRs by 11%, while those that emphasized growth by acquisition underperformed their peers’ TSRs by 11%.

If we fast-forward to the more recent period from 2007 through 2011, some things change and other things stay the same. Most importantly, those that reinvested more of their cash earnings back into the business delivered 8% lower TSRs than their peers, while those that emphasized share repurchases delivered 10% higher TSRs. ("Cash earnings" are earnings before interest, taxes, depreciation, and amortization [EBTDA] minus taxes.)

This is a complete flip-flop. What changed to make reinvestment bad and buybacks good?

Profitability, for one thing, hasn't seemed much different. During both periods, the median industry cash-on-cash returns on capital were about 16.5%, including goodwill and treatment of cumulative spending on R&D as an investment. If reinvestment created value during the prior period at these levels of return, why doesn't it create value during the latter period?

The median price-to-earnings multiple dropped from 24.5x to 16.0x between the two periods, which suggests investors became more pessimistic about the future during the latter period. So it stands to reason that high reinvestment rates are not viewed as positively as they once were.

Pessimism at Work

Indeed, some of this pessimism is at work across the whole market, with investors more cautious since the financial crisis and valuation multiples generally at lower levels. But that seems to be exaggerated in medical devices, perhaps because of such industry-specific factors as the slowing pace of innovation and concern over future profit pressures that may result from reforms of the health-care industry. For example, the 2010 Patient Protection and Affordable Care Act includes an excise tax on the total revenue of medical-device companies, making every dollar of growth less valuable.

The results for investing in acquisitions have gone from bad to worse. The 11% underperformance of acquisitive companies in the earlier period swelled to 22% underperformance in the latter period. In stark contrast to their pharmaceutical and biotech brethren, we find that medical-device companies that deploy more of their cash earnings toward acquisitions tended to perform much worse. It wasn't that these investments were unproductive. The highly acquisitive companies grew their revenue at 21% per year, which was twice as fast as the less acquisitive companies. Two other factors seem to explain why the acquirers delivered lower returns to shareholders.

The first problem was return on capital. The median high acquisition company had cash-on-cash returns of 13% versus 18% for the nonacquirers. Further, the acquirers tended to endure 2% return declines versus essentially flat returns from the nonacquirers.

The second problem was financing. Strategic flexibility is valuable in the medical-device industry, and high debt levels tend to thwart that flexibility. The acquisitive companies issued debt equivalent to more than 20% of their aftertax cash earnings, while the less acquisitive companies reduced their debt burden.

The less acquisitive companies bought back shares with a portion of their cash earnings, and during the latter period those emphasizing share repurchases delivered 10% higher TSR. They also increased their strategic flexibility by building cash balances, perhaps waiting for a more desirable time to invest in their future.

R&D Investment Fares Well

Those that emphasized R&D fared much better than the acquirers. Although the benefit declined in the latter period, those that deployed a greater percentage of their cash earnings toward R&D delivered a modest but positive 4% higher median TSR than their peers.

Some executives are hesitant to increase their R&D spending because accounting rules call for these expenditures to be expensed against current earnings per share. They also worry that the results of current R&D will take time and investors may not be prepared to wait. But it is clear that in the medical-device business, those with ongoing strategies aimed at “making” growth through higher investments in R&D tend to deliver better returns to shareholders than those that “buy” growth by emphasizing acquisitions.

For sure, there are successful acquirers in this industry, such as DENTSPLY and Zoll Medical. But given our research findings, most medical-device company managements would be wise to make sure they are emphasizing internal R&D first and then selectively using acquisitions to fill out their growth strategy.

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