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Smaller medtechs soar in ’17 but could now be too expensive

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Many small groups are up thanks to takeover speculation, and this may end up being self-defeating.

If Align Technology’s 131% share price rise across the past year was impressive, just look at Exact Sciences. The mid-cap diagnostics group nearly quadrupled in value last year, and the overall performance of both mid- and small-cap medtechs indicates that 2017 was a bumper year for investors (see tables below).

But every silver lining has a cloud. The mounting valuations of device makers in this size bracket surely decrease their chances of being acquired by larger groups. In an industry traditionally fuelled by takeovers this could limit the pace of new products coming to market. The irony is that many of these stocks have risen precisely because investors believe the companies might be bought.

Exact, however, is not one of them. An acquisition was last rumoured in summer 2016, with Illumina cast as the buyer. No such deal having emerged, Exact has instead risen spectacularly in value thanks to aggressively chasing widespread reimbursement for its sole product, the colon cancer test Cologuard.

Mid cap ($2.5-10bn) medtech companies: top risers and fallers in 2017			
	Share price	**Market capitalisation ($bn)**	
	12-mth change	**YE 2017**	**12-mth change**
Top 5 risers			
Exact Sciences	293%	6.3	4.8
Ambu	98%	3.8	1.8
Insulet	83%	4.0	1.9
Fisher & Paykel Healthcare	68%	5.8	2.3
Abiomed	66%	8.3	3.4
Top 5 fallers		**YE 2017 ($bn)**	**12-mth change ($m)**
Getinge	(19%)	3.7	14*
Elekta	(16%)	3.1	(315)
Nuvasive	(13%)	3.0	(410)
Convatec	(6%)	5.3	(332)
Dexcom	(4%)	5.0	(59)
**Getinge carried out a share issue in September which caused its market cap to rise. Source: EvaluateMedtech.*			

Private US insurers including Blue Cross Blue Shield and United Healthcare decided to cover the product, and in April Cologuard was added to the star ratings programme for Medicare Advantage plans, strongly incentivising payers to offer it to patients. By October Exact said that 87% of all addressable Americans had coverage for the test.

Combined with a TV ad campaign, this resulted in the use of Cologuard picking up fast. Around 161,000 tests were processed in the third quarter of 2017, an increase of 136% from Q3 2016. At $73m, third-quarter revenues were up 158%.

Despite this the company is still not profitable. It is hiring new sales staff as fast as it can interview them and investors will surely become wary if this situation continues much longer. With a market cap of $6.9bn, Exact Sciences ended 2017 trading at an astonishing multiple of 24x estimated FY2017 sales.

Still, there are around 80 million people in the world who are eligible for colorectal cancer screening, and Exact reckons it can capture around 40% of them. It sold Cologuard at an average of $451 per test in 3Q ’17, and screening is recommended every three years, so if it were to reach this 32 million-strong patient population its annual revenue could approach $5bn. Another quadrupling of the share price in 2018 is unlikely, but cannot be entirely ruled out.

Holding its nerve

Exact may not have risen on takeover talk, but Axogen surely has. The company makes tissue-based nerve grafts including the off-the-shelf extracellular matrix allograft Avance, used to repair defects in the peripheral nerves, and the porcine grafts Nerve Connector and Nerve Protector.

Being highly commoditised, the orthopaedics and surgery sectors see a fair amount of M&A activity as larger groups buy in more innovative technologies to try to differentiate their offerings from their competitors’. So who might buy Axogen? Stryker was highly acquisitive in 2016 and having reined itself in last year it could once again be on the hunt for new deals in 2018.

Other companies that have been mooted as potential acquirers include Zimmer Biomet, Orthofix or Integra Life Sciences. But as with Exact, the risk of Axogen proving too expensive is growing – at the end of 2017 its valuation was 16x its forecast 2017 sales – and again, it has not yet made a profit.

Small cap ($250m-2.5bn) medtech companies: top risers and fallers in 2017			
	Share price	Market capitalisation ($m)	
	12-mth change	YE 2017	12-mth change
Top 5 risers			
Axogen	214%	965	669
Intersect ENT	168%	954	608
Cutera	161%	628	395
Novocure	140%	1,805	1124
Mazor Robotics	135%	1,344	822
Top 5 fallers			
IBA Group	(43%)	841	(524)
Modern Dental Group	(24%)	277	(90)
Natera	(23%)	483	(130)
Cerus	(22%)	386	(64)
Asahi Intecc	(18%)	2,219	(715)
Source: EvaluateMedtech.			

Intersect ENT received US approval for its nasal implant last month, just a week after Stryker bought another maker of nasal devices, Entellus Medical (*Timing of Intersect ENT's approval is on the nose, December 12, 2017*). And Novocure's shares leapt 37% back in April when its Optune device was shown to increase survival in glioblastoma, even though it was already approved for the intractable brain cancer.

And Mazor Robotics is already partnered with Medtronic; many investors will be holding out hope that the world's biggest medtech will buy Mazor outright to aid its attempts to pry some of the robotic surgery market out of Intuitive Surgical's grasp.

Reasons for acquirers to swoop on these mid- and small-cap companies are not hard to find. But investors piling in in the hope of an acquisition may find that they themselves have driven potential buyers away.

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