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Smith & Nephew spend $1.7bn on well-timed ArthroCare buy

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Smith & Nephew's $1.7bn cash purchase of a sports medicine specialist, ArthroCare, means that the orthopaedics giant has made good on its promise to diversify into high-growth areas.

The UK firm says that ArthroCare’s radiofrequency-based surgical technology will mesh with its range of mechanical saws and enable it to treat patients’ shoulders as well as strengthening its knee repair business. The ortho market is enjoying a remarkable resurgence at the moment on the back of improving overall employment rates, thanks to the elective nature of hip and knee replacement procedures, and this deal could help S&N make the most of it.

Reasonable

It is probable that ArthroCare caught S&N’s eye when it reached an agreement with the US Department of Justice last month that resolved a criminal case concerning alleged securities fraud. At the time, analysts at Jefferies and Canaccord Genuity said the company would make an attractive takeover target, and put the likely price at $47-55 per share. The S&N deal comes in at $48.25 per share.

This price tag represents a 20% premium over the 90-day average share price of Texas-based ArthroCare, and the enterprise value corresponds to a 15.7x multiple of 2012 EBITDA. Bernstein analyst Lisa Bedell Clive said that the average multiple in other medtech transactions over the past few years was around 14x EV/EBITDA, but concluded that the price was reasonable.

The deal is expected to close mid-year and to start being accretive in 2015; cost reductions and additional sales will boost S&N’s annual profit by about $85m in 2017, the company said. Integration costs are expected to total $60m over the first three years, with another $40m in transaction costs to come in 2014.

S&N added that it would suspend its $300m share buyback programme, of which it has completed $226m.

Good sports

While the overall orthopaedic market is expanding thanks to an ageing population and increasing rates of obesity, the growing popularity of sport as a leisure pastime has also spurred increased incidence of joint replacement – indeed, S&N’s sports medicine unit is one of the faster-growing parts of the business.

Sports medicine makes up 64% of ArthroCare’s business, according to Ms Clive, with ear, nose and throat products accounting for another 29%. The rest comprises spinal, wound care, urology and gynaecology products. ArthroCare has been hit by the US medical device tax – around 65% of its revenues come from the US – with its estimated operating profit margin in 2013 falling from 20% to 18% in 2012.

But the sports medicine market is relatively undeveloped outside the US, and Smith & Nephew will want to put its heft in Europe and emerging markets – it has recently bought assets based in Brazil, Turkey and India – behind ArthroCare’s devices. And one of the things that characterises developing markets is the growth of a middle class: just the people who are likely to take up running or tennis and find themselves in need of Smith & Nephew’s products.

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