SmartTRAK BioMedGPS

Perspective

Chronology of a Transaction: Smith & Nephew and ArthroCare

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Summary

From early January, 2013 – about the time **ArthroCare** (ARTC) started “reviewing strategic alternatives” – through December 2013, up to nine different companies were contacted about their interest in acquiring ARTC, up to four may have signed confidentiality agreements and actually kicked-the-tires, and at least two expressed interest in acquiring ARTC’s ENT business only. However, even after ARTC confidentially disclosed the terms of the pending deferred prosecution agreement with the US Department of Justice (DOJ) to the few companies still involved in the process, **Smith & Nephew** (SNN) remained the only truly interested party seeking to acquire ARTC’s entire business.

The transaction took four months – from initial meeting of senior managers to announcement – with the usual high stakes negotiations (especially after ARTC’s formal announcement of the DOJ settlement – and their subsequent request for a higher valuation from SNN).

The final purchase price of $48.50 per share reflected a 12.2% increase in value from SNN’s initial non-binding verbal offer of $43.00 per share – but only a 6% increase from its first non-binding written proposal of $45.50 per share. During the process, SNN made four counter-offers to its original verbal proposal.

Summarized below is: 1) An Overview of the transaction, 2) An Overview of ARTC, 3) The chronology of events leading up to the announcement (info secured from ARTC’s Proxy statement), 4) SNN’s strategy behind the acquisition, and 5) Parting observations.

1. Overview of Transaction

On February 3, 2014, SNN announced that it was acquiring ARTC for $1.7 billion (enterprise value of $1.5 billion) or $48.25 per share – a 6.32% premium to the $45.38 per share closing price on January 31. SNN completed the deal on May 29, 2014. Per Scott-Macon Healthcare Investment Banking Report (May 2014), the transaction represented multiples of 4X revenue and 17.8X EBITDA. The transaction is also expected to be "broadly neutral" to SNN's Earnings per Share in 2014 and accretive in 2015 and thereafter. SNN estimated that "significant cost and revenue synergies will add $85 million to annual trading profit by 2017".

The acquisition will allow SNN to become a bigger player in both sports medicine and arthroscopy, dominate the RF Coblation technology space, fill gaps in its soft tissue fixation portfolio and further develop outpatient markets.

2. Overview of ARTC

ArthroCare is a platform technology company that designs, develops, manufactures and markets medical devices built around its Coblation technology – which precisely removes, cuts, coagulates and thermally modifies or sculpts soft tissue through the body.

Coblation is an alternative to traditional mechanical surgical interventions for the treatment and removal of damaged or diseased tissue. It is a non-heat-driven process that uses radiofrequency energy to excite a conductive medium, yielding a focused charged plasma gas. The energized plasma is capable of breaking the molecular bonds within tissue, allowing surgeons to dissolve tissue at relatively low temperatures (40-70 degrees Fahrenheit).

ARTC achieved 2013 revenues of approximately $378 million with 3% sales growth. 64% of revenues were in the US; 36% outside-US. The company is segmented into four major business units: Sports Medicine (about 65% of total sales), Spine, ENT and Other (including royalties and fees; about 5% of total sales).

The Company is also a player in the soft tissue fixation market generating over $80M in revenues in 2013 and holding a 2.7% market share in soft tissue fixation implants, disposables and procedure-specific instruments, according to *SmartTRAK Financial Dashboard*. Approximately 21% of ARTC's total revenues, and approximately one-third of the Company's Sports Med sales, are generated from orthopedic soft tissue fixation devices, according to SmartTRAK estimates. ARTC's distribution model uses direct reps and independent distributors.

SNN (and 2-3 other strategics) distributed several of ARTC's products for a number of years – but apparently did not have access to the "latest generation Coblation product" called Ambient.

3. The Chronology of Events Leading Up to the Announcement

(Note: Info secured from ArthroCare Proxy Statement filed April 3, 2014)

a) January thru July (2013) Events

In early 2013, members of the ARTC management team, Board of Director's (BOD) and Transaction Committee (TC) met with an Investment Bank (IB) to discuss "a wide range of potential strategic alternatives available to the company". These alternatives included:

- Possible acquisition targets,
- An assessment of the companies that might be interested in acquiring the company, and,
- The precedent of companies being acquired during ongoing Department of Justice (DOJ) investigations or after entering into deferred prosecutions agreements

As a result of meeting – and at the direction of ARTC – the IB contacted three medical device companies (SNN was NOT included) from early February through April of 2013 to gauge potential interest in an acquisition of the ARTC. In summary:

- One of the companies signed a confidentiality agreement and met with ARTC management. However, that company chose not to enter into follow-up discussions with ARTC
- A second company informed the IB that it was potentially interested in ARTC's ENT business only. However, ARTC decided there was greater value in keeping the Company as a stand-alone entity versus splitting it into two separate businesses – ENT and Sports Medicine
- The third company had no interest

In early 2013, ARTC also had discussions regarding potential strategic alternatives with a second investment bank (IB-2). In July of 2013, IB-2 informed ARTC that "as part of its ordinary course (of) business development activities", it had meetings with two medical device companies – including SNN – regarding the company's "potential interest in transactions with various potential acquisition candidates, including ARTC". However, IB-2 confirmed that neither SNN nor the other company "expressed an affirmative interest in a transaction with ARTC at the time of the applicable discussions".

b) October thru December (2013) Events

In October of 2013, SNN's President of Advanced Surgical Devices (President) unexpectedly requested a meeting with ARTC's senior management.

On November 5, SNN's President and Chief Corporate Development Officer (CCDO) met with ARTC's President and CEO (CEO), Executive Vice President (EVP), Chief Financial Officer (CFO) and Chief Operating Officer (COO) in Austin, TX to express SNN's interest in exploring a potential acquisition of ARTC as a result of the following:

- SNN had just completed the process of integrating certain recent acquisitions and was ready to explore potential new acquisitions,

- SNN believed its orthopedic business line had matured in such a way that a complementary acquisition would be attractive, and
- ARTC had recently announced that it was involved in discussions with the DOJ to resolve the investigation into allegations of securities and related fraud committed under a previous management team

Shortly after the meeting, SNN's internal and outside legal advisors began negotiating the terms of a potential confidentiality agreement.

That same day, ARTC senior management met with the IB to discuss:
- Potential responses to SNN's inquiry, and
- Possible timing and process for engaging with other potential third parties that "might have the financial capability and strategic interest to pursue a potential transaction with ARTC"

On November 12, SNN signed the confidentiality agreement with ARTC.
Starting on November 18, in anticipation of potentially receiving an offer from SNN, the IB began to contact certain other medical device companies regarding a potential acquisition of ARTC. Thru early December, the IB reached out to five medical device companies (in addition to SNN), including two of the three potential acquirers contacted by IB at the request of Company in early 2013 (Note: The Company who expressed interest in ARTC's ENT-only business was not re-contacted). ARTC ultimately entered into confidentiality agreements with three of the companies (in addition to SNN), including one of the companies who had signed a confidentiality in March of 2013. However, at various times following meetings with ARTC management, each of the three companies indicated "they were not interested in pursuing an acquisition of ARTC at that time, either without giving a reason for their decision, because they were not interested in an acquisition of the entire Company but might be interested in an acquisition of only its ENT business or because they were not prepared to explore a potential acquisition with the Company or make an offer to acquire the Company at that point in time".

On November 19, the Leadership Teams of ARTC and SNN met. SNN's CCDO confirmed that SNN would not be interested in a multiple-bidder process to acquire the Company and proposed entering into an exclusivity agreement with ARTC – with the intent to expeditiously conduct its required due diligence and negotiate satisfactory terms to acquire the Company.

On November 25, the ARTC BOD held a special telephonic meeting, which included outside Legal advisors, and considered and approved the terms of a proposed deferred prosecution agreement with the DOJ. Immediately following the call, ARTC's Transaction Committee formally selected the IB to represent the Board as financial advisor. The following day, ARTC entered into an engagement letter with the IB in connection with the potential sale of the Company.

In December 10, SNN's CCDO called ARTC's CEO and informed him that SNN's Board had:

- Authorized him to present a preliminary, non-binding acquisition proposal at a price of $43.00 per share of SNN common stock in cash, contingent on completion of due diligence,
- Reiterated that SNN would be unwilling to participate in any auction process, and
- Stated that SNN would require a 60-day exclusivity period as a condition to its continued exploration of a potential transaction with Company.

Note: SNN's $43.00 per share proposal reflected an 11.54% premium to the $38.55 per share closing price of ARTC's common stock on December 10.

On December 13, ARTC's Transaction Committee held a telephonic meeting with outside legal advisors and the IB and authorized ARTC's President/CEO "to inform SNN that the proposed purchase price of $43.00 per share in the initial proposal was financially inadequate and ARTC would seek a price proposal of at least $50.00 per share". In addition, the TC:

- Determined that it was not in ARTC's best interests to enter into exclusive negotiations with SNN at the $43.00 per share proposed price,
- Determined that financial buyers would be unlikely to match the price offered by SNN (and other potential acquirers) due to "synergies that those strategic aquirers would expect to be able to realize through an acquisition", and
- Instructed the IB to contact two additional medical device companies not previously contacted

On December 16 and 17, the IB contacted the two new device companies. By December 20, both companies confirmed that they were not interested in acquiring ARTC.

On December 16, ARTC's IB informed SNN that its offer was "financially inadequate".

On December 18, ARTC received a written non-binding acquisition proposal from SNN to acquire all the outstanding shares of common stock of ARTC at a price of $45.50 per share in cash. The offer was (primarily) subject to:

- Satisfactory completion of due diligence,
- Negotiation of a definitive merger agreement, and
- A termination fee equal to 4.5% of the equity implied by the offer price

In addition, the letter indicated that SNN wished to enter into exclusive negotiations with ARTC for a period of 45 days (vs. the 60-days originally requested).

Note: SNN's $45.50 per share price reflected a 14.04% premium over the $39.90 per share closing price of ARTC's common stock on December 18.

On December 18 and 19, during a regularly scheduled ARTC BOD meeting – attended by IB and outside advisors – the following was decided:

- There were no other currently viable potential acquirers of ARTC – including private equity and financial investors – who were likely to pay a price higher than SNN to acquire the Company and complete a transaction in a timely manner, and
- The Board authorized management to negotiate with SNN in order to obtain a higher price, a reduction in termination fee and elimination (or reduction) of exclusivity time period

On December 19, the ARTC IB contacted the SNN IB to propose a non-binding counter-offer to SNN – a purchase price of $47.00 per share and a termination fee equal to 2.5%. On December 20th, ARTC's CEO called SNN's CCDO to propose the same.

On December 22, SNN's CCDO called ARTC's CEO to say he was authorized to present the Company a revised non-binding proposal to acquire ARTC at $46.00 per share, along with a termination fee equal to 3.5%, and an exclusive negotiation period ending February 5, 2014. The offer was "SNN's best and final" one and reflected a 16.75% premium to the $39.40 per share closing price on December 20.

Later on December 22, ARTC held a special telephonic meeting and the BOD provided authorization for management to enter into an exclusive agreement with SNN.

On December 26th, ARTC entered into a written exclusivity agreement with SNN that contemplated a non-binding purchase price of $46.00 per share, a termination fee equal to 3.2% and provided for a binding exclusivity period ending January 21, 2104 – with an automatic extension to February 4, unless the Company gave notice of termination on or before January 15.

Note: The $46.00 per share price was a 14.91% premium to ARTC's $40.03 per share closing price on December 26.

On December 30, ARTC provided SNN with access to its electronic due diligence data.

c) January thru February (2014) Events

Between January 3 and 28, various calls were conducted and meetings held between the ARTC and SNN teams to address business and legal due diligence questions.

On January 7, ARTC issued a press release confirming that Company had entered into a deferred prosecution agreement (DPA) with the DOJ. The terms of the agreement were materially the same described to all serious potential acquirers and consistent with amounts reserved for the matter by ARTC in public filings.

Note: ARTC's closing price on the day following announcement was $46.57, an increase of 14.48% from the $40.68 closing price the day before.

On January 10, during due diligence meetings, senior managers from SNN and ARTC met to discuss SNN's non-binding price of $46.00 per share in cash in light of the DPA and subsequent increase in ARTC's share price. SNN's CCDO confirmed he would discuss matter with SNN's Board. In turn, ARTC emphasized need for SNN to provide "more closing certainty".

On January 12, ARTC's legal advisors sent SNN's legal advisors an initial draft of proposed merger agreement.

On January 13, ARTC's IB contacted SNN's IB regarding SNN's willingness to increase its per share proposal. SNN's IB stated that SNN hoped to send a revised proposal – at a higher price – on January 14, prior to the next ARTC BOD meeting.

On January 14, ARTC's TC held a telephonic meeting with management, legal and the IB. Since SNN's revised proposal was not received, the TC directed management to terminate SNN's exclusivity period in accordance with terms, and extend exclusivity until January 24 in order for SNN to complete its DD and submit a revised proposal.

On January 15, ARTC gave notice to SNN that it was exercising its right to terminate exclusivity on January 21 but that it would continue to abide by the terms of the exclusivity agreement until January 24.

On January 17, based on SNN's CCDO assurances that a revised price proposal – with a premium to the then-market price – would be forthcoming, ARTC's CEO confirmed that ARTC would extend exclusivity until January 24, and that exclusivity would remain in place thereafter as long as good faith negotiations were continuing.

On January 21, ARTC publicly announced the dismissal by the DOJ of the pending civil investigative demand. The day following the announcement, ARTC's share price was $47.72.

On January 24, SNN's CCDO called ARTC's CEO and confirmed the following:

- SNN's due diligence was substantially completed,
- SNN intended to provide a revised price proposal on January 29 – following SNN's Board meeting – at a premium to the then current $47.05 per share, and
- SNN intended to deliver a draft merger agreement on January 25 (which it did)

On January 29, SNN's CCDO called ARTC's CEO to deliver a revised, "stretched", non-binding purchase price of $48.00 per share (a 4.78% premium to ARTC's $45.81 per share price on January 29) in cash – good until January 30 at midnight CT.

That same day, ARTC's TC conducted a telephonic meeting with outside legal and their IB and decided to inform SNN that it would need to raise its proposed price to a $50.00 per share – in an effort to extract from SNN the highest price it was willing to pay to acquire ARTC – and provide more closing certainty related to regulatory matters.

Later that day, ARTC's IB informed SNN's IB of ARTC's latest requirements.

On January 30, ARTC's CEO called SNN's CCDO regarding SNN's increasing its proposed price. The CCDO said SNN would wait until after the close of the markets on January 31 to consider increasing its proposed price. The next day, CCDO informed CEO that SNN would provide a revised price proposal on February 1, pending progress on the merger agreement.

On February 1, SNN's CCDO called ARTC's CEO to confirm that SNN would revise its proposal to offer $48.25 per share ($1.7 billion) and that "SNN would not offer any further increases". The $48.25 price reflected a 6.32% premium to the $45.38 per share closing price on January 31.

That same day, ARTC's BOD authorized its IB to negotiate final terms of definitive merger agreement with the goal of presenting agreement to the Board the following day.

On February 2, ARTC's BOD held a telephonic meeting. Their IB delivered an oral opinion that the proposed transaction price was fair. In turn, the Board recommended approval of the merger agreement, which was then signed by ARTC and SNN.

On February 3, SNN issued a press release announcing the merger agreement.

On May 29, following approvals from all antitrust regulators, SNN announced completion of the transaction.

4. SNN's Strategic Rationale behind Transaction

Based on presentations made by SNN senior leadership team, the strategic rationale included:

- Creation of a comprehensive resection and repair portfolio with growth prospects:
    - In resection, the combination of ARTC's latest generation of radio frequency (RF) technology and SNN's strong mechanical blade portfolio gives customers greater choice
    - In joint repair, ARTC's shoulder anchor innovation complements SNN's strength in knee repair, forming an extensive, integrated portfolio

- Additional revenue opportunities from combined global footprint and channel presence:

    - Cross-sell the combined portfolio and build upon shared capabilities in marketing and customer targeting
    - Utilize SNN's more extensive and established global footprint to introduce ARTC's products to new customers and markets

- Adjacent Ear, Nose & Throat (ENT) business provides new growth opportunities:

    - Ability to expand this business into new global markets
    - Prospects to utilize SNN's technologies to develop product range further

- An enhanced pipeline:
    - Strong combined new product pipeline and R&D expertise will accelerate delivery of future innovation

5. Parting Observations

- ARTC was able to overcome its troubled history – including a severely declining stock price several years back, indictments of former executives, lawsuits and a DOJ investigation – and successfully conclude a transaction.
- SNN paid $1.7 billion cash to acquire ARTC – a significant transaction – yet has taken a back-seat to other "more glamorous" industry deals (or proposed deals):
    - SNN's acquisition of ARTC has been over-shadowed by several other mega-mergers that were announced either immediately before and after SNN's press release about ARTC went public – including the Stryker/ MAKO transaction (concluded during Q1/14) and the pending Zimmer/ Biomet and Medtronic/Covidien deals
    - In addition, ConMed – a major sports medicine company – announced that it was "exploring a sale". And on top of that, Stryker and Medtronic were mentioned as potential acquirers of SNN

- Any seller needs only one highly-motivated buyer:
    - Stryker (SYK) was the only party at-the-table during its pursuit of MAKO
    - SNN was the only company pursuing ARTC's entire business

- The "first offer" was a lower-end, verbal, non-binding one in order to solicit a response, but the counter-offers got slightly richer as the negotiation process moved forward:
    - SNN's initial verbal offer to ARTC was $43 per share; its initial written proposal was $45.50; its final price was $48.25 per share
    - In its effort to acquire MAKO, SYK's initial verbal offer was $21 per share; its initial written proposal was a "$24-$26 range"; its final price was $30 per share

- SNN's acquisition of ARTC–- similar to SYK/MAKO – is not without its challenges. SNN must deliver on its post-deal promises regarding sales and cost synergies and tightly manage the post-deal integration process.

For additional information about the SNN/ARTC transaction, please check **ARTC's Form PREM14A** (Proxy Statement – Merger or Acquisition Preliminary) filed on April 3, 2014.

Don Urbanowicz is Principal of Urbanowicz Consulting, an advisory firm with a musculoskeletal focus seeking to enable clients to achieve strategic and transaction-related goals by capitalizing on market opportunities. UC offers a unique perspective on how large global companies approach strategy, valuation, negotiations, due diligence and integration, and a thorough understanding of achieving success throughout all phases of the transaction process.

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