Chronology of a Transaction: Stryker and K2M

The deal secures a top-three spine market position for Stryker

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Introduction

The Stryker (SYK)/K2M transaction took eleven months – at least from signing of the confidentiality agreement by SYK and K2M in September of 2017, to the deal announcement in August of 2018 – including an early, two-month "lull-in-the-action" and most recently, some post-announcement drama.

The transaction, expected to close in late Q418 faced opposition when, five weeks following the deal announcement, some K2M investors filed suits to block the shareholder vote on the transaction. The suits argued the proxy statement for the acquisition did not accurately reflect K2M's financial projections and undervalued K2M. However, on October 23, K2M released additional details regarding its financials and the disclosures resulted in the plaintiffs dismissing their suits.

SYK also filed to extend the anti-trust deadline to allow the FTC more time to examine the deal. The filing pushes the waiting period out to November 16.

During the transaction process, two other companies (in addition to SYK) approached K2M (or its representatives) to discuss the merits of a potential transaction – one in August of 2017 and another in May of 2018. However, discussions with the first did not develop beyond a preliminary stage and K2M did not pursue the second. In addition, K2M's representatives reached out to three companies (one *possibly* an "overlap") in April of 2018 – but none were interested in a potential transaction – making SYK K2M's *only* suitor.

SYK's final purchase price of $27.50 per share reflected a 1.9% increase in value from its initial non-binding offer of $27.00 per share. During the process, SYK made two counter-offers – one at $27.35 and its final at $27.50 per share. The board of directors for both companies approved the transaction. A K2M shareholder vote regarding the buy-out is scheduled for early November. The acquisition must also meet customary closing conditions and regulatory approval. Post-closing, K2M will become a wholly owned subsidiary of SYK.

SmartTRAK provides an analysis of the deal, including the value proposition, the rationale behind it, and key insights, along with a chronology of events and timeline up to the date in which the transaction is expected to close.

What's the Deal?

On August 30, SYK announced it signed a definitive agreement to acquire K2M in a transaction valued at ~$1.4B. The deal represented a 26% premium to K2M's closing stock price on August 29 and an ~27% premium over the previous 90-day average share price. The all-cash offer valued K2M at ~5.4x 2017 sales, ~4.8x the mid-point of 2018 guidance of $289.5MM, and ~4.5x of estimated 2019 sales.

Virtually all industry analysts felt the valuation was reasonable, given comparable transactions in Med-Tech overall and spine specifically, and K2M's top-line growth profile offset by the fact that the company had been unprofitable. Guidance for 2018 called for a net loss of ~$36MM and a very modest Adjusted EBITDA of between $4 to $8MM.

K2M's Value Proposition

K2M Group Holdings, Inc. is currently a global, pure-play, publicly-traded spine company generating the majority of its revenue from implants and instruments used in spine surgeries. The company's products primarily treat challenging spinal pathologies, including deformity, trauma, and tumor. K2M also sells minimally invasive spine products and implants for degenerative spine. K2M has also become an innovator in 3D-printed spinal implant technology – where it has perhaps the broadest portfolio of products in the market.

Over the past five years, the combination of K2M's portfolio and sales force has driven a double-digit compounded annual growth rate. K2M was seeking to deliver sales of between $288 and $291MM in 2018, an estimated 12-13% increase – in a market that BioMedGPS estimates will see roughly flat to low single-digit growth year-on-year. The company generates about 75% of its sales in the US and 70-80% of its total sales from its indirect network of distributors. However, as mentioned, K2M had been unprofitable and projected only modest Adjusted EBITDA for 2018.

Rationale Behind the Acquisition

A) Secures a "Top 3" position for SYK – finally – in the spine implant market:

- Spine has remained a challenging business for SYK – and one of its few business units lacking a “Top 3” market position. The K2M transaction will be the strong tuck-in acquisition that SYK needed to capture incremental, meaningful share and become more relevant in Spine. Based on H118 *SmartTRAK Financial Dashboard*, the combined companies (barring any post-closing sales dis-synergies) will have a 12.9% US share (SYK at 9.0% and K2M at 3.9% share respectively) in the spine implant segment – in a tie for third with NuVasive (also at 12.6%) – and behind Medtronic (27.2%) and JNJ DePuy Spine (17.6%).
- Based on H118 *SmartTRAK Financial Dashboard*, the combined companies will also have a 13.6% US share in the thoracolumbar fusion segment (SYK at 8.9% and K2M at 4.7% share respectively) and a #4 position behind Medtronic, JNJ DePuy Spine, and Nuvasive. On the cervical fusion side, a SYK and K2M entity will have an 11.1% share (SYK at 7.6%; K2M at 3.7%) and a solid #3 position in the US behind Medtronic and JNJ DePuy Spine.

B) Broadens SYK’s portfolio and fills a strategic portfolio gap:

- SYK will expand its degenerative and MIS product portfolio’s and, given K2M’s large range of 3D printed implants complemented by SYK’s own, offer surgeons the most comprehensive portfolio of FDA-cleared, 3D printed spinal implants on the market.
- K2M’s global leadership in complex (deformity, trauma, tumor) spine, including a well-established network of surgeons and distributors, will offer SYK a strong foothold in this area – which historically has had minimal payer pushback and been insulated from pricing dynamics. In addition, securing presence in complex spine will allow SYK to go head-to-head with two key competitors – JNJ DePuy Spine and Medtronic. (Note: BioMedGPS estimates K2M’s complex spine share at ~15%).

C) Leverages SYK’s strengths and provides complementary products and upsell opportunities:

- K2M’s product portfolio leverages SYK’s existing call points in the OR, its global footprint, and its go-forward R&D efforts.
- The complex spine and 3D printed implants, in particular, will provide door openers for the SYK sales representatives and create selling opportunities for “other” portfolio products

D) Adds a critical piece to SYK’s leadership team:

- Once the transaction is successfully concluded, K2M Chairman, CEO and President – Eric Major – will become President of the SYK Spine business. With over 20 years of spine experience, Major will provide leadership and perspective to SYK.

E) Provides K2M shareholders with a fair valuation *and* an excellent partner:

- K2M shareholders will receive a reasonable valuation given: (1) comparable take-outs in Med-Tech and spine, (2) K2M's top-line growth profile -- offset by the fact that the company had been unprofitable and its 2018 guidance called for a very modest EBITDA of $4 to $8MM, and (3) an all-cash offer from its lone suitor – SYK.
- SYK has a proven track record in M&A over the past six years under the leadership of CEO Kevin Lobo. The company has also demonstrated a "post-transaction competency" following its numerous, successful medical device deals.

Key Insights

- The SYK/K2M transaction is expected to successfully conclude late Q418.
- Strategically, SYK and K2M are an excellent fit with the combined entity well positioned for future share growth in the spinal implant market, and with only minimal product overlap.
- SYK walked away from the K2M transaction once in early December 2017 – but for only a one week period.
- SYK ran a disciplined process and stayed true to its tight valuation range. The company made two counter offers to K2M, reflecting only a 2% increase in valuation from its initial offer. Contrast this to other earlier "Chronology Transactions" published by BioMedGPS:
    - SYK's acquisition of MAKO and Pipeline where SYK made two counters to its initial offer – but in a much wider valuation range – a 25% increase from its initial written offer and a 43% increase from its initial verbal offer,
    - SNN's purchase of Arthrocare where SNN made four counter offers increasing its valuation of Arthrocare between 6% (from 1st non-binding written proposal) and 12% increase in valuation (from initial non-binding verbal offer), and
    - Zimmer's acquisition of Biomet where Zimmer made two counters to its initial offer between an 11% increase (initial non-binding verbal offer) and a 5% increase in valuation (the company's final offer).
- Best guestimates of the identities of Company's A, B, C, and D (as outlined in the deal chronology below) are the "usual suspects" – Medtronic, JNJ DePuy Spine, NuVasive, Globus, and/or Zimmer Biomet (in no specific order). Each company offered different

reasons for passing on K2M including product overlap, expected near-term earnings dilution, and inconsistent strategic priorities.

- K2M's financial advisor, Piper Jaffray (P-J), did not believe that any potential private equity (PE) players would have a meaningful interest in or an ability to acquire K2M – they felt PE buyers would typically prefer to acquire companies with significant cash flow, a box K2M could not check.
- Over the past five years, spine transactions with overlapping businesses have performed rather poorly, primarily due to sales force integration and channel disruptions. In order to minimize these issues, SYK appears intent on leaving the K2M sales channel intact. Appointing Eric Major as President of the SYK Spine Division post-closing will also help minimize disruptions. However, competitors – including NuVasive and Globus – are certain to exploit SYK's sales dis-synergies.
- SYK does expect cost synergies, but given the Company's retention of the K2M sales force and K2M's high operating costs, the savings are expected to be on the General & Administrative Expenses (G&A) side.
- K2M may be required to pay SYK a $47.6MM termination fee – if SYK terminates due to a Company Adverse Recommendation Change *or* if K2M terminates due to entering into a definitive agreement with respect to a Superior Proposal from another Company. SYK negotiated the right to match any competing proposal that the K2M Board determines "superior" – so little to no chance of a "late-suitor" jumping into the fray.
- K2M has agreed to pay P-J a transaction fee of $21.4MM, which is contingent upon the consummation of the transaction – except for $1MM which was already paid to the advisor for rendering a fairness opinion.
- Finally, consolidation in Spine will continue – but post-deal integration will remain an absolute key.

Chronology of the Acquisition

(Info secured from K2M Proxy Statement, Schedule 14A, October 5, 2018 - click here)

A) 2014 Thru July 2017

- Following K2M's IPO offering in 2014 through the middle of 2017, members of K2M senior management occasionally had discussions regarding K2M's business with representatives of industry participants, including SYK, regarding potential transactions with K2M. None of these discussions developed beyond a preliminary stage.

B) August Thru December 2017

- In August, representatives of Company A reached out to Piper Jaffray (K2M's financial advisor) to propose a meeting with K2M to discuss the merits of a transaction in which Company A would acquire K2M. A confidentiality agreement – which did not include a stand-still provision -- was executed in late August.
- Follow up discussions between Company A and K2M, which did not address valuation, ultimately did not develop beyond a preliminary stage based on both companies view of the business and their product redundancies.
- In September, members of SYK's management team contacted K2M regarding a potential meeting to discuss a basis for a possible business combination. On 9.29, K2M and SYK executed a confidentiality agreement.
- On 10.3, representatives of SYK's and K2M's management teams met in Washington, D.C. The parties did not discuss any potential transaction terms, including price. On 10.20, management teams of SYK and K2M conducted a call, which included a discussion regarding follow up questions from SYK.
- On 10.17, The K2M Board held a meeting, which was attended by K2M senior management and Piper Jaffray (P-J). SYK's interest was reported to the Board. Further, P-J provided their views on a potential transaction with SYK, including the potential synergy opportunity to SYK and the possible impact that such an opportunity could have on SYK's valuation of K2M in a possible acquisition. K2M's Board determined that K2M's management should continue to provide information to SYK and be receptive to further exploratory discussions with the Company about a potential transaction.
- Following the Board meeting and through November, K2M periodically provided info to SYK, but no substantive discussion about a potential transaction took place. On 11.30, SYK notified K2M that it was no longer interested in pursuing a transaction.
- However, on 12.7, Eric Major (EM) met with Kevin Lobo (KL)/SYK Chairman and CEO in Washington, D.C. at an industry conference both attended. During this meeting, EM and KL discussed engaging in further exploratory discussions about a potential transaction in the future.

C) January Thru April 2018

- In January, at the request of K2M, representatives of P-J met with SYK. It was agreed that management from K2M and SYK should meet again in the near term in furtherance of their 2017 preliminary discussions.

- On 2.14, members of the K2M and SYK management teams met in NYC. Both parties discussed the potential benefits of a business combination, including the potential synergies or cost savings, but there were no discussions regarding terms of such a transaction.
- Between mid-February and mid-April, K2M continued to provide information to SYK pursuant to the previously executed confidentiality agreement. However, specific transaction terms remained undiscussed.
- At an April K2M Board meeting, P-J pitched the possibility of contacting a select group of third parties to determine their interest in discussing a potential transaction with K2M – and identified five strategic companies (B, C, D, E, and, F), excluding SYK. Following review of each Company's profile and the advantages and disadvantages of contacting the identified third parties beyond SYK, the Board felt it was prudent to (1) continue discussions with SYK, and (2) contact Company's B, C, and D only – since K2M had already explored potential transactions with each in previous years – with the admission that such discussions had not developed beyond preliminary stages.
- For the following two weeks, through the end of April, P-J contacted Company's B, C, and D. Although each had a positive view of K2M, none were interested in pursuing a potential transaction with K2M. Each Company offered different reasons, including product overlap, expected near-term earnings dilution, and inconsistent strategic priorities.

D) May Thru June 2018

- In May, a strategic company in the medical field, Company G, contacted P-J to inquire about the possibility of entering discussions with K2M regarding a business combination. P-J promised to inform the K2M Board of the overture.
- In mid-May, Bradley Paddock (BP), President of SYK Spine, informed Eric Major that SYK remained interested in K2M and expected to discuss with SYK senior management the possibility of submitting a preliminary indication of interest (IOI) for K2M. BP indicated that it was possible that no IOI would be forthcoming and did not commit to any specific timing.
- On 6.5, at a regularly scheduled K2M Board Meeting, P-J confirmed that SYK continued to pursue a transaction – but had not initiated any discussions around transaction terms, including price, and that SYK did not commit to delivering any IOI on any specific timing or at all. The K2M Board agreed to the following: (1) continue to provide SYK with information "for the time being" and remain receptive to ongoing dialogue about SYK's interest in K2M, (2) discontinue contact with Company's B, C, and D – unless they made

an inquiry, (3) refrain from contacting Company's E and F, and (4) following a review of Company G's profile and the advantages and disadvantages of pursuing a transaction (including Company G's likely all-stock or majority-stock consideration leading to a "significant relative valuation disparity and potential operational dis-synergies between K2M and Company G"), P-J was instructed to inform Company G of K2M's lack of interest in pursuing a transaction with them.

E) July Thru August 2018

- On 7.16, Tim Scannel (TS), Group President, Medsurg and Neurotechnology at SYK, and Spencer Stiles (SS), President, Instruments of SYK, met with EM. The SYK contingent informed EM that the Company was prepared to seek authorization from its Board – in early August -- to submit a preliminary non-binding IOI relating to an acquisition of K2M, although both confirmed that it was possible that no IOI would be forthcoming. In addition, TS and SS mentioned SYK's desire for certain members of K2M's existing management team to join the combined K2M/SYK spinal business, and in fact, retaining certain members of K2M's management team had become a meaningful factor in SYK's continued interest in pursuing a transaction with K2M.
- On 7.19, KL called EM to primarily reiterate the messages conveyed by TS and SS two days earlier.
- On 7.25, representatives from Citigroup (Citi), SYK's financial advisor, called P-J to confirm SYK's continued interest in K2M, the Company's intent to remain disciplined regarding any purchase price, and that any bid by SYK would likely include a request for an exclusive negotiation period due to the significant expense SYK would expect to expend. Citi also inquired as to whether K2M would be open to indicating what it would expect in terms of any potential purchase price.
- On 7.26, the K2M Board held a meeting -- and following much discussion and critical review of analysis -- concluded: (1) any further outreach to other potential buyers would not likely lead to a transaction and could create additional "leak risk", (2) providing "some general valuation guidance" to SYK was the best next step in terms of eliciting a price indication from SYK that could lead to actionable discussions regarding a potential transaction, and (3) the valuation guidance would be "in the high $20's" per share in order to continue discussions. Later that day, P-J called Citi to inform them of K2M's "high $20's" valuation guidance range.
- On 7.27, P-J made K2M's financial projections available to Citi. The closing price per share of K2M common stock on the 27th was $19.68.

- On 7.30, representatives of K2M and P-J discussed projections with SYK and Citi representatives.
- On 8.3, SYK submitted to K2M's Board a non-binding IOI to acquire 100% of the shares of K2M common stock at a price of $27 per share in cash, subject to negotiation of definitive transaction documents and confirmatory due diligence. As part of IOI, SYK also requested a four-week exclusivity agreement with K2M with respect to the negotiation of a definitive transaction. That same day, representatives of SYK called EM to emphasize SYK's desire to promptly understand whether K2M's Board would be willing to engage on the terms of Stryker's IOI. The closing price per share of K2M common stock on the 3rd was $21.77.
- Following a K2M Board meeting on 8.4, the Board requested that P-J respond to SYK with a counter-proposal of $28.50 per share in cash and a proposed exclusivity period of three weeks. The Board also requested a "go shop" provision that would allow K2M to solicit competing proposals for a limited period of time following the announcement of a transaction. P-J made K2M's counter later that day. In the evening, Citi delivered SYK's response: (1) The Company was not receptive to the proposed $28.50 per share offer, but would increase its proposal to $27.35 in cash per share, (2) it could agree to a three-week exclusivity period, and (3) the "go-shop" provision was unacceptable, but acknowledged that any definitive agreement would provide the K2M Board with a customary fiduciary termination right.
- On the morning of 8.5, the K2M board held a telephone meeting and the following was concluded: (1) the Board would agree to proceed ahead with the transaction with SYK on the basis of an increased consideration of at least $27.50 per share in cash and (2) the Board would accept SYK's position to not provide for a "go-shop" in light of the fact that any definitive agreement would provide the Board with a customary fiduciary termination right. Later that morning, P-J representatives spoke with their Citi counterparts about the K2M Board's conclusions. That afternoon, representatives from Citi informed P-J that SYK was amenable to K2M's latest proposal and later that evening, SYK's outside counsel submitted a draft exclusivity agreement which provided a three-week exclusive negotiating period. The following day, the Company's respective counsel negotiated and entered into an exclusive negotiation period thru 8.27.
- From 8.7 thru 8.29, K2M provided SYK with access to its online data room, continued to populate the data room in response to SYK's requests, and participated in due diligence calls with SYK, its financial advisors, and outside legal counsel.

- On 8.13, SYK's outside counsel delivered an initial draft of the merger agreement to K2M's counsel. Included was a termination fee of 3.75% of the equity value of the transaction, and an obligation of K2M to reimburse SYK for its expenses upon a termination of a merger agreement if the K2M stockholders did not approve the proposed transaction.
- On 8.17, following another K2M board call, K2M's counsel sent a revised draft of the merger agreement to SYK's counsel, which included a termination fee of 3.0% of the equity value of the transaction and a rejection of the proposed provision requiring K2M to reimburse SYK for its expenses if the K2M stockholders did not approve the transaction.
- On 8.21, SS contacted EM and updated him on the progress of the due diligence and expressed optimism that a mutually acceptable agreement on key remaining issues could be shortly reached.
- Between 8.22 and 8.24, SYK counsel requested 72-hours beyond the expiration of the exclusivity agreement (or thru 8.30), a request that was granted by the K2M Board – but for 48-hours only (or thru 8.29).
- Between 8.25 and 8.29, outside counsel of both companies continued to negotiate the terms of the merger agreement and reached agreement on the following (1) termination fee would be ~ 3.4% of the equity value of the transaction and (2) K2M would not be obligated to reimburse SYK for its expenses in the event K2M stockholder approval was not obtained.
- Between 8.27 and 8.29, Eric Major – thru separate outside legal counsel engaged by EM and approved by the K2M Board – negotiated the terms of an offer by SYK to serve as President of its Spine division following the consummation of the proposed merger.
- On 8.29, the K2M Board approved the merger and merger agreement, resolved that the merger agreement be submitted for consideration by the K2M stockholders, and recommended that the K2M stockholders adopt the merger and approve the transaction. That evening, K2M and SYK finalized and executed the merger agreement. In addition, EM executed SYK's offer letter to serve as President of Spine. The closing price per share of K2M common stock on the 29th was $21.82.
- On the morning of the 30th, K2M and SYK issued a press release announcing the execution of the merger agreement.

F) Post-Announcement Events (September-December 2018)

- The closing price of the K2M common stock on 10.4, the most recent practicable date prior to the filing of Proxy Statement, was $27.27 per share.

- On 10.11 and 10.12, several K2M investors filed suits to block the November shareholder vote on the transaction, arguing the proxy statement for the acquisition did not accurately reflect K2M's financial projections*and* undervalued K2M. One plaintiff asked the Delaware court to expedite the case and grant a preliminary injunction barring consummation of the deal.
- On 10.19, K2M countered that the plaintiffs presented no sound evidence justifying a delay and confirmed its intention to "vigorously defend" against the suits.
- On 10.19, SYK filed to extend the anti-trust deadline to allow the FTC more time to examine the deal.
- On 10.23, K2M released additional details on its financials and the plaintiffs dismissed their suits.
- On 11.7, a K2M shareholder vote regarding the buy-out has been scheduled
- By 11.16, a response regarding anti-trust is expected from the FTC
- By 12.31, the transaction is expected to close

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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