MANAGING MEDTECH PORTFOLIOS FOR SUSTAINABLE GROWTH

By Colm Foley, Sahil Sanghvi, and Raph Mannino

As the quest for innovative medical technology products becomes more challenging, especially during the coronavirus pandemic, creating value increasingly requires more than focusing on individual product lines. Portfolio management—the practice of making decisions and tradeoffs regarding various investments or businesses—is also vitally important. But many companies find managing a medtech portfolio an uphill battle.

The key to successful management is to focus investments on a relatively small number of businesses—specifically, younger ones that have the highest potential return, rather than more mature, lower-growth ones. Selecting the right businesses is challenging, however, given the inherent difficulty of choosing which performance metrics to prioritize, the vast number of strategies available, and the relentlessly high expectations of investors.

BCG's article on portfolio management's role in creating value discusses how to evaluate each business in order to optimize total shareholder return (TSR). This article builds on that discussion, providing medtech companies with a hands-on approach for dealing with all types of investments, both organic and inorganic, and a rigorous portfolio management methodology.

The Challenges of Portfolio Management

Medtech portfolio managers, often a role filled by general managers, typically handle complex portfolios: they are made up of multiple businesses that have facilities and customers around the world, and the performances of the businesses can vary dramatically. In the same portfolio, we've seen gross margins across product lines range from 40% to 80%. Likewise, operating profits can range from the midteens to 40%; investment levels for selling, general, and administrative (SG&A) expenses can vary from 10% to 45%; and R&D spending can range from 2% to 15%. And even if profit and loss (P&L) statements are similar for various businesses, mature product lines may have negative organic growth rates, while those for breakthrough innovations may well exceed 20%.

Our analysis shows that companies with a high TSR skew their investments toward the businesses in their portfolio that have the highest financial returns. This makes sense. What's surprising is that companies with the highest TSR skew their investments dramatically differently from companies with the lowest TSR. Companies with a high TSR are making bold choices and finding ways to richly fund high-return businesses while reducing investments in low-return businesses. Companies with a low TSR are not. (See Exhibit 1.)

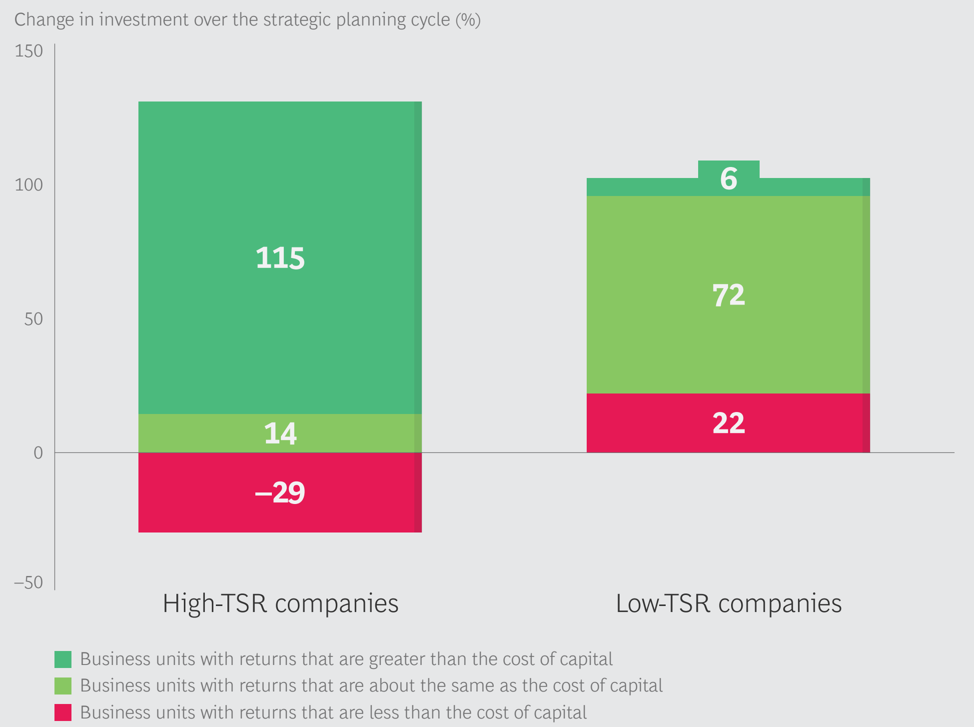
Focusing on the best opportunities is not as easy as it sounds. The medtech executives whom we've spoken with said that they contend with six fundamental challenges.

Too Many Choices. A complex portfolio can present a bewildering array of investment options and tradeoffs. Portfolio managers often make decisions without complete information. Tethering a portfolio assessment to a clear and prioritized set of objectives, with a systematic review of plausible alternatives, is a must.

A Bias in Favor of Current Allocations. Too many companies allow current investment levels to dictate future investment decisions. But as core products mature, portfolio managers need to take into account the likelihood that today's leading businesses and product lines will give way to newer, more innovative entrants.

Short-Term Constraints. Financial constraints are very real. Companies can't fund every good business that they have. Rather, companies need to restrict their choices to those that can generate enough cash over the medium term to fund longer-term objectives. That means avoiding the temptation to rob longer-term, path-breaking innovation of critical investment in order to liberate near-term profits or fund incremental improvements.

EXHIBIT 1 | Companies with High Returns Focus on the Best Investment Opportunities



Sources: Standard & Poor's Compustat; BCG analysis.
Note: TSR = total shareholder return. High and low TSR are defined relative to the median TSR.

Acquisitions That Are Dilutive Short Term, Even if They Accrete to Value Long Term. Many medtech companies find it challenging to drive innovation by making acquisitions, because the most innovative early-stage companies dilute earnings per share or profits, even if they have the potential to create significant shareholder value and transform the portfolio in the midterm or the long term. Seasoned medtech managers find ways to offset dilution, often by more aggressively managing more mature businesses in the portfolio.

Inability to Divest. Portfolio managers rightly feel that they are stewards of a corporate legacy. But even businesses central to a company's identity are not immune to a natural life cycle. Nor are those businesses always appropriate for a portfolio whose center of gravity needs to shift toward better opportunities.

Investor Expectations. General managers of large, multiline medtech businesses often have product lines that compete against high-growth pure-play competition. High-growth pure-play companies are often rewarded by investors for reinvesting profits in the growth of the business, even if this means minimal short-term profitability. In contrast, investors expect short-term profit growth from large multiline medtech companies. General managers of large multiline companies often ask how they are supposed to fund R&D and sales and marketing for the growth businesses in the same way that pure-play competitors do, while increasing bottom-line profits. This particularly tough challenge further increases the need for multiline managers to make tough tradeoff decisions in their portfolio of potential investments.

A New Approach to Portfolio Management

The best medtech portfolio managers don't compromise. They analyze the businesses in their portfolio and develop an investment plan that is likely to generate the highest returns. However, even the best managers should ensure that they are following five important steps.

Decide on the performance metrics for the portfolio as a whole. Choosing the right target metrics is a complex undertaking, simply because a selection can have unintended consequences. For example, a portfolio manager who adopts a metric that measures businesses' three-year revenue growth rate implicitly makes it harder for businesses to fund innovations, which typically require more time than that to prove themselves. Even if such innovations eventually have a higher net present value, a three-year revenue metric will discourage businesses from funding them.

To identify the right metrics, a portfolio manager should start by classifying each of the businesses in the portfolio. Medtech businesses fall into one of five categories:

- **Alpha Growth.** These businesses are expected to operate as growth engines, driving significant top-line revenue either in the medium term or in the long term.
- **Growth.** These organizations grow faster than a specified multiple of the GDP; they are expected to generate revenue in the nearer term, compared with alpha-growth businesses.
- **Balanced.** These businesses have growth at a reasonable price (GARP).
- **Harvest.** These organizations generate significant cash but have limited growth prospects.
- **Value.** These businesses, also known as turnarounds, can be a source of profits through portfolio rebalancing and strict cash management.

We have used Wall Street investor terminology for these categories because, even at a group or divisional level, it helps connect the strategy of the individual business back to the strategy of the parent corporation.

Note that a business does not have to be in the growth or balanced category to create substantial shareholder value. What's key is that the portfolio manager make sound and timely investment and disinvestment decisions.

In addition, since today's alpha-growth business is likely to become tomorrow's GARP business, it's critical to review the type of each business regularly. Put another way: if a portfolio remains static, the company is likely to be headed for trouble.

After classifying each of the businesses, the portfolio manager can develop performance metrics for each individual business as well as for the portfolio as a whole.

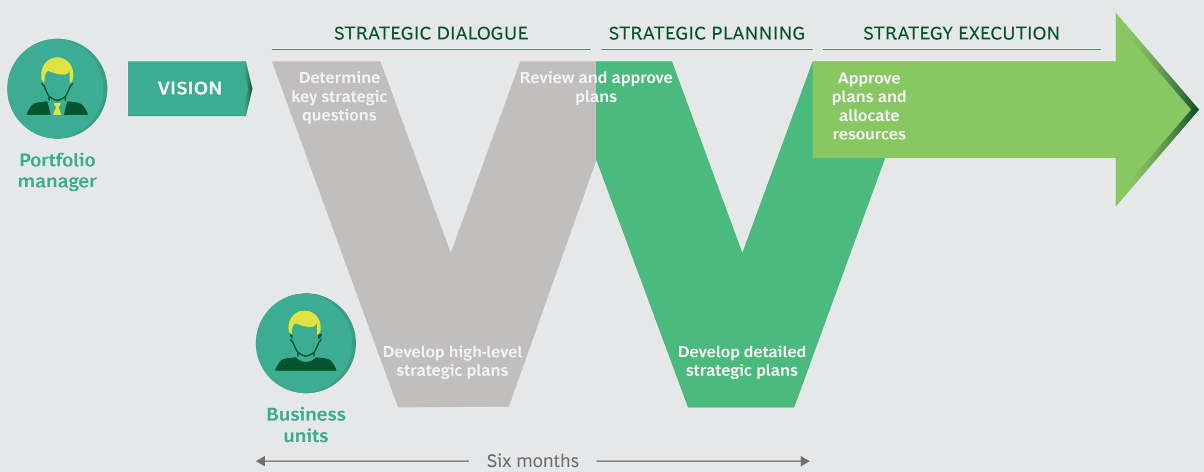
Understand the potential investment scenarios for each business. While the portfolio manager is identifying the performance metrics, business unit managers should develop multiple scenarios for allocating investments. This requires temporarily setting aside top-down mandates that detail specific investment goals, such as the specific compound annual growth rate that an investment plan must achieve or the maximum percentage of revenue that a business can invest in R&D. Typically, only two or three alternatives make sense. A value business, for example, rarely needs to develop a plan to achieve alpha growth.

The scenarios from the business unit managers need to be comprehensive, including not only potential investment opportunities but also projections for future growth, profitability, and cash generation. Only with comprehensive information can the portfolio manager determine if the cash from one business can fund an investment plan for another business. To facilitate top-down and bottom-up communication during this process, we recommend using the W method. (See Exhibit 2.)

Use a data-driven approach to manage tradeoff discussions. After collecting the potential investment scenarios for each business, the portfolio manager should create scenarios for the portfolio as a whole. BCG's optimization tool can help. (See Exhibit 3.) The tool shows how much the investment profile of a business can vary depending on the ultimate objective (such as maximizing profitability, revenue, or free cash flow) and the constraints that are deployed—or not. Therefore, the tool allows the portfolio manager to see the full range of what's possible, and it reveals which investments are likely to bring the highest returns. It is especially useful when many investments are under consideration.

For example, a portfolio manager in a large medtech company had identified dozens of potential growth paths but didn't know how to evaluate them. Further complicating matters was a set of challenging P&L

EXHIBIT 2 | The W Method Facilitates Communication



Source: BCG analysis.

Exhibit 3 | BCG's Optimization Tool Clarifies Where to Focus Investments

Simplified example

Three metrics:
- Three-year EBITDA
- Five-year revenue
- Ten-year free cash flow

P&L constraints:
- Gross margins ≥ 60%
- R&D ≤ 10%
- Operating expenses ≤ 20%
- EBITDA ≥ 40%

Portfolio scenarios	Optimize for three-year EBITDA	Optimize for five-year revenue	Optimize for ten-year free cash flow
EBITDA CAGR (three years)	**5%**	4%	4%
Revenue CAGR (five years)	4%	**7%**	4%
Free cash flow CAGR (ten years)	3%	4%	**6%**
Implications for investment focus			
Business A	Growth	Accelerated growth	Divest
Business B	Accelerated growth	Growth	Accelerated growth
Business C	Momentum	Momentum	Momentum

Source: BCG analysis.
Note: EBITDA = earnings before interest, taxes, depreciation, and amortization.

constraints that the corporate parent had imposed. These included minimum gross-margin percentage requirements and caps on R&D and SG&A expenditures.

The portfolio manager used BCG's optimization tool to evaluate the investment scenarios both with and without constraints. The results were revealing. With the significant P&L constraints, projected revenue growth over a five-year period would never exceed 5% CAGR per year in any scenario. But without those constraints, revenue would exceed 7% CAGR per year, revealing approximately 200 basis points of potential growth.

These results allowed the portfolio manager to see the true potential of the company's various businesses—those that merited more funding and those that needed to be divested. The manager used the findings to hold a facts-based conversation with senior executives at the parent company about the growth potential for the business unit and whether P&L constraints should be adjusted. The portfolio manager also looked for operational improvements that could help fund the growth of certain businesses if the P&L constraints were left in place.

Communicate clearly internally and externally. It's imperative for the portfolio manager and business unit managers to communicate clearly to internal stakeholders throughout the process, especially after investment decisions have been made.

Communication outside the walls of the organization is also critical, though it does not occur on the same level of detail. Still, a company should let outside investors know its expectations regarding risk level, timing, and cash flows. After all, investors are placing bets on the company and, therefore, have the right to decide the role that the stock will play in their portfolios.

We frequently see a disconnect between what the portfolio manager thinks investors want and what investors actually want. So it's critical for the portfolio manager to be clear and make sure that everyone is on the same page. The best portfolio managers communicate the logic for the investment plan to the corporate parent or investors, explaining whether the plan repeats the past or breaks from it. For example, if the plan calls for R&D spending to rise by 0.5%, the portfolio manager would explain which investments would be funded and the implications for short-term growth and longer-term shareholder value creation.

Execute on portfolio decisions. The portfolio manager's investment decisions should inform the execution of the overall portfolio strategy, including whom the portfolio manager selects to manage each of the various businesses, what the goals are for each business, and how success is measured. The individuals who are appointed to manage each business report to the portfolio manager. They must have the skills and motivation needed to succeed, and the criteria used to measure performance must be carefully selected in order to hold them accountable.

THE INVESTMENT DECISIONS that companies make across their complex business portfolio can have a palpable impact on financial value. Undoubtedly, some decisions will involve tough tradeoffs. And in an industry as broad and diverse as medtech, the results will at times be unpredictable and dramatic, especially during a crisis like the one we're experiencing now. But portfolios guided by this five-step approach can support innovation efforts and foster sustainable value in the years ahead.

About the Authors

Colm Foley is a managing director and senior partner in the Chicago office of Boston Consulting Group. You may contact him by email at foley.colm@bcg.com.

Sahil Sanghvi is a managing director and partner in the firm's Minneapolis office. You may contact him by email at sanghvi.sahil@bcg.com.

Raph Mannino is a partner in BCG's Chicago office. You may contact him by email at mannino.raph@bcg.com.