2013 M&A Report:
Audiology & Hearing Aid Industry

By
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Introduction

As the third quarter of 2013 comes to a close, it’s time to take the pulse of M&A activity in the audiology and hearing aid industry. Earlier this year we noted in our Year End M&A Report: Audiology Industry that 2012 was a banner year for sellers, as corporate acquisitions continued to outpace sales to private individuals or other small practice owners by a wide margin, driving sky-high valuations while facilitating an exit during a favorable economic and tax climate. Now, as we examine how 2013 has unfolded thus far and we gaze into our crystal ball to predict what the future holds, we see that M&A activity remains strong in the face of changes that have had varying impacts on deal activity.

Last year, we estimated total transaction value of roughly $100 million, with $30 million worth of deals closing in December. While we expect the total number of transactions to decrease this year, there were two significantly large transactions in the first half of the year that will bring total value in 2013 in line with the previous year. We therefore predict another $100 million year.

Our estimates consider only the acquisition of privately owned audiology or hearing aid dispensing practices in the United States and do not measure transactions involving other entities within the industry. Furthermore, this figure only measures deals initiated in 2013. Many deals involve deferred payments, and millions of dollars will be spent covering obligations incurred from transactions that closed in previous years; however, in order to accurately assess deal volume for a given year, only transactions closed in that year can be measured.

Buyer Activity

The key variable in the market continues to be corporate buyers, and they remain as strong as ever. As we’ve written in previous reports, the corporate buyers dictate valuations and drive up transaction volume. Economic factors certainly play a role, but tend to have a much lower impact as long as corporate buyers are in the mix.

Rumors are constantly swirling around the corporate buyers, and I often hear statements like “Company A is slowing down” or “I heard Company B is having cash flow problems.” While each company has their own dynamics and certain companies have recently redirected their M&A strategies, the overall impact on the market has been minimal. One buyer did decelerate from late-2012 to mid-2013, but they have since ramped back up their acquisitions; they have shifted their strategy to focus more narrowly on specific markets, but when they find practices in those areas they will continue to act aggressively. Another buyer recently replaced its entire top management team; the new management has a different vision for acquisitions and retail ownership, and I expect them to pursue fewer deals this year but they will still be present in the market. In the face of all this, new companies have entered the fray. With each departure or deceleration matched by the entrance of a new player, the market should remain resilient in the face of change.
The next question, then, is how valuations are impacted by the ebbs and flows of the corporate buyers. As we frequently write, corporate buyers establish the valuations for any industry, and the hearing aid space is no different. And so far this year, we’ve seen valuations remain strong. Valuation methods, however, are beginning to change. In the past, revenue drove valuations. Most corporate buyers considered cash flow and profitability and incorporated those items into their models, but revenue and total hearing aid sales were the leading indicators. Today, some buyers still value practices based on revenue, but a trend favoring cash flow is emerging.

This trend marks the natural evolution in the consolidation cycle. The early acquirers thirst for market share and pay aggressive, revenue-based multiples in order to build as quickly as possible. Over time, their goals shift from rapid market share growth to bottom line expansion. While some newer buyers are driven by revenue expansion and therefore continue to pay the revenue-based prices, other recent entrants have focused on profitability from day one.

The end result is this emerging trend toward profitability-based valuation methods, which can have positive and negative effects on sellers. A highly profitable practice can continue to attract numerous buyers willing to pay premium prices, while those reporting below average profitability will receive fewer offers and may see their values take a hit. Over time, a continued shift toward cash flow-based models may bring down valuations industry-wide.

An emerging positive trend is the growth of non-corporate buyers. More industry outsiders are interested in the industry, exhibiting a willingness to invest in practices of all sizes. Furthermore, Au.D. programs are beginning to incorporate private practice and general business principles into their coursework. The industry is still a far cry from other similar industries in which the majority of graduates expect to become a practice owner one day (e.g. dentistry); however, the increased attention given to practice ownership has fostered an increase in the number of young audiologists who would rather own a practice than work for someone else. In addition, organizations like ADA and numerous buying groups are working hard to match their members who wish to sell a practice with prospective buyers. Finally, funding from industry sources continues to be readily available, making it easier for someone to buy a hearing aid practice than many other types of businesses.

**Seller Activity**

On the seller side of the equation, the outlook remains attractive. There continues to be a disproportionate number of practice owners in the late stages of their careers, and the number of owners planning their exits should increase in the next 5-10 years. The presence of corporate buyers will bolster valuations for the next few years, making it possible for owners to continue to exit at very attractive valuations.

Prospective buyers should find the industry very attractive for investment over the next 10+ years. As the number of practices for sale increases, buyers will have more choice among practices in which to
invest. Furthermore, as the corporate buyers begin to slow down, individuals and smaller companies will face less competition, allowing them to win more deals.

**Outlook for 2013-15**

We expect M&A activity to remain strong over the next three years, with the strategic buyers acting as the driving force behind an active market, and the resources supporting the independent buyers filling in the gaps. While 2014 may not generate as much total deal value (total dollars spent) as 2013, due to the two aforementioned transactions that skew the results, we expect the total number of closed transactions to equal 2013. Furthermore, we predict that 2012-14 will mark the peak of M&A activity in the recent consolidation phase, if not in the history of the industry. We expect a slowdown to start in 2015; 2015 and 2016 should still be very strong years, but the drop-off should become increasingly noticeable as we reach the end of 2016.

Beyond 2016, the outlook becomes murky; the corporate buyers may turn their attentions to secondary and tertiary markets, or they may wind down their acquisition programs altogether. At this point, I doubt even the CEO’s of these companies can say with any relative certainty what they will be doing in three years.

The key differences between selling a practice in the next 18-24 months and waiting longer will be the time it takes to sell and the valuation. As the changes in buyer behavior suggest, the corporate buyers will become more and more selective as time goes on. Gone are the days of the “we’ll buy anything, anywhere, we just want the market share” mentality. The focus instead is on penetrating the top 20-30 markets, strengthening existing holdings outside of these markets, and selectively buying very large, very profitable practices in outlying areas (e.g. >$2 million in revenue). Sellers fortunate enough to operate in these markets can expect competition among buyers for the rights to buy their practice, and the attractive valuation that goes along with competition. Those who don’t align with these new objectives, however, will face growing uncertainty.

What will it mean, then, when the corporate buyers begin to disappear? There will still be plenty of buyers in the market, but they will look, feel, and act differently. The international conglomerates and hearing aid manufacturers will give way to smaller, regional consolidation plays – private investors and existing practice owners seeking to build mini-empires of 20-50 locations along with smaller-scale practice owners who just want to expand to a second or third location. These buyers will create an active market that helps sustain transaction volumes close to what we see today; however, they may not be able to sustain today’s values and will likely establish new rules of thumb for valuing practices.
Trends

In our last report, we highlighted five trends in the M&A landscape. Rather than coming up with a new list just for the sake of being different, we decided to examine these same five trends to determine what has changed in 2013. We have also incorporated a recommendation of how to capitalize on each trend.

Valuations:

**What we said then:** Purchase prices remain strong for those selling to corporate buyers. Deals valued at "one times sales" or greater still occur; however, only when the buyer is a corporation and most of the time when the deal involves complex terms.

**What we see now:** Not much has changed here. Valuations are strong and deals valued at 1x Sales or greater still occur when corporate buyers are involved. The major change, as highlighted previously, is the valuation methods that are being used. Increasingly, buyers are weighting cash flow more heavily than revenue, benefiting those practices with above average profitability and hurting those that are underperforming.

**Recommendation:** Focus on driving profitability. Clean up your financial statements, reduce overhead, and streamline your operations to create a business that will generate sustainable EBITDA in excess of 15-20% for a new owner. We can’t stress the importance of cash flow enough – follow this advice, and you will reap incredible rewards when you sell.

If you find yourself unable to increase profitability, consider selling sooner. Today, you can still receive offers based on revenue, but the longer you wait the less likely that becomes.

**Earn-Outs Bridge Valuation Gaps:**

**What we said then:** Earn-outs are commonly used by corporate buyers to bridge valuation gaps. These are the most complicated deal structures, but do allow a seller to maximize the purchase price as long as the business is able to achieve certain targets in the years following closing.

**What we see now:** The prevalence of earn-outs in transactions has decreased some this year, and many of the performance-based bonus payments incorporated into transactions are now based on profitability when historically they were based on revenue. This should not come as a huge surprise, given the overall shift toward a focus on cash flow. This shift has created more diversity among deal structures, as the decrease in traditional earn-outs (e.g. revenue-based) has given way to more cash offers, deferred payment structures, and the aforementioned profitability-based bonuses.
Recommendation: If you want to maximize your value in a transaction, be prepared for some type of structured deal rather than an all cash deal. It is very rare for a seller to receive 100% of the purchase price at closing unless they accept a discounted price. Approach the transaction with an open mind so that you can weigh as many options as possible.

Owner Employment Agreements:

What we said then: Corporate buyers still prefer to retain the owner for 2-3 years after closing. They pay competitive salaries and many offer benefits, although it is usually a pay cut compared to what the seller earned as an owner. As corporate buyers increase their market share, they exhibit an increased willingness to forego the employment agreements, but typically only if they already have a presence in the market and the owner is not a major revenue contributor.

What we see now: We’ve seen some divergence in the length, structure, and necessity of employment agreements. Whereas in the past it was almost a given that a corporate buyer would require the owner to agree to a 3-year employment agreement, today we see some deals in which the requirement is waived altogether, a handful in which it is required but the term is reduced to 1-2 years, and many that require up to 4-5 years of continued employment. Three factors contribute to such variability. First, it’s the owner; if the owner sees a lot of patients and generates significant revenue, it is borderline impossible to replace them immediately. Second, each buyer has different strategic objectives and certain companies choose to forego the employment agreements when they can. Finally, it’s the deal structure; earn-outs and performance bonuses typically go hand-in-hand with continued employment, and an owner with a growing business who wants to be rewarded for future performance is better off accepting employment so they have more control over their ability to earn their bonuses.

Recommendation: Be open-minded and don’t wait until you absolutely have to sell to begin talking to buyers. Put yourself in a position to walk away immediately if a buyer doesn’t need you, but with the flexibility to continue working for 3+ years if that’s what it takes to maximize value. If your business is growing and you want to be rewarded for its continued growth, plan on some type of structured earn-out in order to maximize those rewards.

First In Gets the Lion's Share:

What we said then: Buyers like to make a big splash when they enter new markets, typically acquiring practices with a minimum of $1 million in annual sales and preferably with multiple locations. They will then complete subsequent acquisitions of smaller practices to bolster their presence, but the first to sell in a market always receives the most lucrative deal.

What we see now: No change here. This is a rule of thumb in any industry.
**Recommendation:** Be strategic, but be reasonable. If you recognize that corporate buyers desire a presence in your market, talk to them. Position yourself to solicit bids from multiple buyers and capitalize on your leverage in the situation. Make sure you understand the value of your business and a likely outcome from a transaction. While you may be in an attractive position to capitalize on this demand, the corporate buyers do have a breaking point and will walk away if you hold out for too high of a price. Once you cross this line it’s tough to go back – unless you grow significantly they will always view you as the person who wants too much, and in the meantime they’ll probably buy your competitor instead.

**Markets:**

**What we said then:** Large, profitable practices will always attract buyers, regardless of the market; however, practices in the top 20 metropolitan areas are the most desirable. Expect to see a continued focus on these markets, especially cities like Chicago and Dallas that today don’t have a strong presence of corporate-owned practices.

**What we see now:** No change here. Add New York, Houston, and key markets in Florida and California to the list of cities attracting the most buyer interest.

**Recommendation:** This is one element that is out of your control. Unless you’re planning to move, focus on growing and optimizing your business to meet the other criteria.

**New Trends:**

**Emergence of “non-corporate” buyers:** The percentage of non-corporate buyers is on the rise. This group includes audiologists and hearing aid dealers buying their first business, existing independent owners expanding through acquisition, and industry outsiders who want to invest in a healthy, growing industry. Attractive market dynamics, easy access to capital, and an abundance of sellers means these buyers will continue to find practices to target, and as the corporate buyers wind down their acquisition programs, these buyers will begin to replace them as the most common acquisition partner.

Of this group, the industry outsiders will be the most interesting to watch as they have the ability to prolong the consolidation wave. They will likely stay dormant as long as the corporate buyers remain aggressive, because they cannot compete on valuation, but we know many private equity investors who have specific interest in this space. The challenge most of them face is that they need their first acquisition, known as a platform, to meet specific revenue and/or EBITDA criteria that is tough to find among hearing aid practices. Most seek $10-20M of revenue and a minimum of $1M in EBITDA. Once they invest in a platform, however, they can make add-on acquisitions of much smaller companies.
Many of the same trends will apply to these buyers, specifically the desire to retain quality owners and the concept of first in getting the lions share. Typically, the owners of platform companies are offered equity in the new entity and can be rewarded a second time when the fund exits their investment. When successful, these are very lucrative events. Eventually, some private equity groups will figure out a way to invest, and when they do expect them to flex their muscles and aggressively seek expansion through additional acquisitions.

Late Breaking News

As we prepare to publish this report, news broke that private equity firm KKR will buy Panasonic’s healthcare business unit for $1.67 billion. Among the products in Panasonic’s portfolio: hearing aids. Panasonic has been an intriguing and somewhat mystifying brand since their entrance in the hearing aid market. While they possessed the potential to leverage their strong consumer brand and disrupt the market by bypassing the traditional distribution channels, they instead chose the same strategy as the Big Six manufacturers – pricing them as a big ticket item and selling to audiologists and dispensers.

KKR is one of the world’s largest private equity funds and they are one of the groups rumored to have bid when Siemens put their hearing aid unit on the auction block. KKR has not made public any of their plans for Panasonic, so only time will tell whether they plan to continue utilizing traditional distribution channels or redirect their efforts toward a direct-to-consumer strategy. The same goes for retail investments. While they face numerous options, for all we know they may have no interest in hearing aids and could just as easily ignore or exit the space.

The deal is expected to close in March, 2014. We’ll be eagerly anticipating the outcome one of the world’s premier private equity group’s attempts to tackle the hearing aid industry.

Conclusion

Today’s M&A climate is very strong, and we remain bullish on the prospects for sellers in the next few years. If our tone turns somewhat negative when we describe the longer term outlook as bleak, consider this: M&A activity is at an all-time high in the hearing aid industry today, and if we believe that it is peaking now then we naturally have to predict a decline at some point in the future. Compare this space to other comparable spaces like dentistry or speech pathology, however, and you’ll find some startling differences. Audiology and hearing aid practices sell for 2-3 times their counterparts in one of those other fields, and transaction volume, when measured as transactions per 100 practices, dwarfs that of the other two professions. Even if a decline is on the horizon, the owner of a hearing aid business faces much brighter prospects whenever they decide to sell.

Owners who are not ready to sell today but plan to in 5-10 years will certainly face a different climate. They will compete with more sellers for the same buyers, and negotiate with buyers who value practices in a very different fashion from today; however, as long as hearing aids continue to be a high-margin,
private pay business there will always be buyers. And if you show me an industry with a steady presence of buyers, I’ll show you an industry with an attractive M&A environment.
About the Author

Craig A. Castelli is the Managing Director of Bridge Ventures and founder of its Chicago office. He is a Certified Transaction Advisor and member of the Association of Professional Merger & Acquisition Advisors. He has 10 years of audiology industry experience and has worked with hundreds of private practices. He has extensive experience in both buying and selling hearing aid practices, and is one of the only independent experts in the field. Mr. Castelli resides in Chicago with his wife, Shannon, and his daughter, Maren. He enjoys golf, skiing, and Marquette University basketball.

About Bridge Ventures

Bridge Ventures is a middle market merger and acquisition firm specializing in assisting privately held businesses with revenues ranging from $500 thousand to $50 million. We provide expertise for current and future small business owners looking to sell, buy, or grow a company. The majority of our clients are owners of private audiology and hearing aid practices who hire use to assist in the sale of their companies. We have offices in Chicago, IL and Tampa, FL.

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