DaVita Health Care Partners Inc. (DVA) Memo

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Company Description

Founded in 1994 and headquartered in Denver, Colo., DaVita HealthCare Partners Inc. is a leading provider of dialysis services in the U.S. to patients suffering from chronic kidney failure, also known as end stage renal disease (ESRD). The company operates kidney dialysis centers and provides related medical services primarily in dialysis centers and in contracted hospitals across the U.S. Its services include outpatient dialysis services, hospital inpatient dialysis services and ancillary services such as ESRD laboratory services and disease management services. In Nov.2012, DaVita changed its name to DaVita HealthCare Partners Inc. from DaVita Inc., following its merger with HealthCare Partners. However, HealthCare Partners operates as a subsidiary of the holding company.

Thesis / Key Points

- **Healthy and static growing business model of continuous M&A.**
  - Acquiring dialysis centers and businesses that own and operate dialysis centers, as well as other ancillary services and strategic initiatives has been DaVita's preferred business strategy over the past several years.
  - Expanding sizes and numbers of clinics and centers is the root of expanding revenues since DVA's dialysis services should be mainly implemented in clinics. More clinics means more machines sales, more services provided and more patients attracted. (Exhibition)
  - Acquiring clinics instead of building ones by DVA can be seen as a wisely cost-saving strategy.
  - During 2012, the company increased its total outpatient dialysis centers by 145, and in the first half of 2013, DaVita acquired 11 centers and opened 45 centers in the U.S. It also acquired and opened 13 centers outside the U.S.
  - Its M&A with HealthCare Partners in Nov.2012 was supporting and augmenting the company's primary care and specialty physician services as well as hospital and other healthcare services.
    - This merge brought about a network of 667,000 patients and 700 physicians under DaVita's umbrella, better positioning the company to deal with uncertain changes in Medicare reimbursement. Last quarter, HealthCare Partners generated $803 million in revenue, which is 27% of DaVita's top line. (Exhibition)
  - Other expanding M&A include the acquisition of ModernMed, the rival company DSI Renal Inc., and a segment of DVA's biggest competitor Fresenius Medical Care in the recent two years. These M&A not only expanded DaVita's client base, but also provided access to new areas of work.
- **Promising and steady approach to international markets in the foreseeable future.**
  - Compared with its main competitor Fresenius, DaVita is much more dependent on the U.S. dialysis market. By comparison, only 66 of DaVita's 2108 dialysis centers are located in non-U.S. countries by 2012 while Fresenius only generated 66% of its revenue from North America.
  - However, DaVita has been ramping up its international expansion efforts to catch up to Fresenius greatly in 2013.
    - Over the past years, DaVita has expanded its global reach through significant acquisitions and alliances in the rapidly developing economies of Saudi Arabia, China, India and Germany, among others. The company also seeks to expand its presence in Europe and has been seeking acquisition and partnership opportunities in all major European and Asian countries.
    - In Jun 2013, the company entered Columbia; in Jan 2013, it acquired 5 centers in Portugal and 4 in Poland from Fresenius; in Jan 2013, it also entered Taiwan through a joint venture; in Dec 2012, it acquired one and opened two centers in Malaysia; it began a strategic alliance with Cureatr in Jun 2013 to improve nationwide communication and care coordination among care teams at dialysis center; it acquired the dialysis operations of Caring Dialysis Centre Group in Malaysia in Jul 2013 to strengthen its foothold in Malaysia.
  - We could expect more meaningful mergers and acquisitions, given the company's strong international reputation that provides competitive advantage in terms of global acquisitions, which will help it, enhance its operating leverage further.
- **Super Strong operating cash flow.**
  - DaVita has been generating strong operating cash flow accruing from improved earnings, robust cash collections and the timing of payments for working capital expenditures.
  - The strong cash flow allows the company to meet its capital expenditure needs and spend on acquisitions.
  - Net operating cash flow has significantly increased by 99.96% to $733.13 million when compared to the same quarter last year. Operating cash flow increased at a 3-year CAGR (2009-2012) of 18%. For the first half of 2013, operating cash flow increased 28% yoy mainly due to improved cash earnings, and is expected to increase in the range of $1.35- $1.50 billion in 2013, reflecting consistent growth in future as well.
  - Moreover, DaVita tries to generate cost efficiencies through various deals and alliances. While the company's 7-year Epogen purchase deal with Amgen Inc., enter in Nov 2011, has marginally increased the cost of Epogen in the near term, it will receive various discounts and rebates over the tenure of the agreement. Also, the agreement limits Amgen's ability to increase Epogen's price without the consent of DaVita. Thus, the deal is expected to significantly reduce the company's future expenditure on the drug.

Misperception

commercial payers as the primary payer, the shift in payer mix will be harmful considering the Medicare Advantage reimbursement rate cuts for 2014 announced by the Centers for Medicare and Medicaid Services (CMS) in April 2013.
  - However, on Nov.26th, CMS announced that it would only reduce payments to kidney dialysis providers by less than 1% over the next two years in contrast to proposed cuts of as much as 12%.
  - However, in the environment of increasing expenses, the cuts of $30 per treatment over the next two years will not play big roles in patients' payment.
- The debt-to-equity ratio of 1.98 is quite high overall and when compared to the industry average, which triggered market concern about the high debt problems under numerous existed and potential M&A.
  - However, DVA's quick ratio is comparatively strong at 1.12, demonstrating the ability to handle short-term liquidity needs.

VAR

- Dr. Kevin McConnell in Jefferson Nephrology: "… DaVita is almost the most reputable dialysis centers in the state. I would strongly recommend patients with acute kidney disease to ask for help in their centers and ones with chronic disease stage 5 to keep going to DaVita until they make the renal transplant…"
- Yan Qin, associate chief physician at Nephrology Department, Peking Union Medical College Hospital: " …when I was the visiting scholar at National Institutes of Health in U.S., I heard of DaVita as largest kidney disease center in America. My mentor once led me to go through their dialysis equipment and I realized about the big gap about conditions for kidney disease between China and U.S… If you could afford the fee to get high-end chronic kidney disease services and even the renal transplant, I would highly recommend you to go find DaVita in U.S…"
- "I am grateful for the information my caregivers provided about vaccinations," said DaVita patient Joe Garcia at DaVita Beevile Renal Center in Beeville, Texas. "Since I also work as a school bus driver, it's important for me to stay healthy and now I understand how getting vaccinated plays a vital role in my health." DaVita also performed education for patients with kidney disease for various ways, including the free vaccine recently in all of their centers.
- "I personally love the recipes on its websites and the instructions about healthcare in their centers. I received guidance all day long and planed my diet from their guidance." Mary Wyatt, a patient of DaVita in South Virginia.

How It Plays Out

- Over the past few years, DaVita has shown continuously smart M&A to smoothly expand its clinics and to strengthen its market-leading position in U.S. DVA can be expected to further use means of acquisitions and alliances to steadily expand the business.
- 10% of Americans suffer from chronic kidney disease and 8.3% are living diabetes, which both require dialysis. Combine those factors with a rapidly aging population (Exhibition), we could make the conclusion that the market for dialysis treatments will continue growing over the next few decades. Therefore, companies like DVA, which dominates clinical dialysis, will continue rising. Also, compared with its mainly competitor Fresenius, DVA is much smaller than Fresenius but it has higher growth potential, indicated by lower PEG and P/S ratios.

Risks / What Signs Would Indicate We Are Wrong?

- The company depends on future borrowings to service its indebtedness and fund liquidity needs with its elevated level-debts.
  - DaVita issued senior notes in Aug 2012, to finance the acquisition of HealthCare Partners, apart from using its free cash balance. This has increased DaVita's interest by $57.5 million annually, which will weigh on its already high expenses. The issuance also increased the company's total debt, thereby deteriorating its financial leverage.
  - DaVita may face difficulties in expanding its business, take advantage of business opportunities, respond to competitive pressures or refinance maturing debt, if additional debt refinancing was unavailable on acceptable terms.
- In order to hedge against interest rate fluctuations, the company entered into interest rate swap agreements, interests rate forwards swap agreements and interests rate cap agreements in Mar 2013. However any increase in interest obligations may further increase the company's interest expense and adversely affect the earnings and cash flow and ability to service its debt.
- The impact of the health care reform legislation could adversely affect DaVita s earnings. While some provisions of the legislation went into effect in 2010 and 2011, most provisions will be implemented from 2014. One such provision, which requires the establishment of health insurance exchanges, is a cause of concern for DaVita. The exchanges are expected to reduce the number of policyholders opting for commercial insurance. Moreover, even those policyholders who choose to stay with commercial insurance are likely to opt for policies with limited benefits, carrying lower reimbursement rates. Consequently, the establishment of the exchanges could adversely affect the earnings and cash flow of DaVita.

Signposts / Follow-Up

- Check the annual report or 10-Q whether its operating income could match its promising third quarter guidance of $1.88-1.92 billion.
- Also follow-up of its debt improvement in the 4th quarter.
- Be careful about any changing projection of fees of CMS for its Medicare program.
- Follow up of its future M&A in international market.

Important Company Financial Data

- DaVita's third-quarter 2013 operating EPS was $0.98 compared with $0.76 year-ago.
- Total Revenue increased 54.1% yoy to approximately $3.0 billion from $1.95billion.
- Operating Cash Flow amounted to $733.1 million, up from $366.6 million year ago.
- Comparatively lower PEG ratio of 1.24 and P/S of 1.08 indicates higher growth potential.

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Exhibition1: DaVita's Treatments Increase Chart.

Davita's Operating Statistics		Decrease / Increase
Number of Treatments (thousands)	5,867.97	7.63 %
Number of treatment days	78.00	0 %
Treatments per day (thousands)	75.23	7.63 %
Dialysis revenue per treatment ($)	338.86	1.86 %

Exhibition2: Strong Revenue Growth that beats the market.

DVA Revenue Growth Rate Comparisons	Company	Industry	Sector	S&P 500
Y / Y Revenue Growth (Q2 MRQ)	48.81 %	11.62 %	-3.08 %	1.26 %
Q / Q Revenue Growth (Q2 MRQ)	1.49 %	1.16 %	3.62 %	1.9 %
Y / Y Revenue Growth (Q2 TTM)	35.83 %	6.96 %	-1.98 %	%
Seq. Revenue Growth (Q2 TTM)	10.24 %	2.8 %	-0.78 %	0.32 %
Revenue 5 Year Average Growth	9.31 %	4.36 %	3.45 %	2.9 %
Expected Revenue Growth (Y/Y)	-	4.9 %	7.87 %	5.02 %

Exhibition3: Above-industry-Average Effective Management

DVA Management Effectiveness	Company	Industry	Sector	S&P 500
Return On Assets (Q2 TTM)	3.92 %	3.91 %	8.9 %	2.7 %
Return On Assets 5 Yr. Avg.	4.89 %	5.65 %	7.76 %	2.09 %
Return On Investment (Q2 TTM)	4.52 %	4.65 %	10.93 %	4.84 %
Return On Investment 5 Yr. Avg.	5.65 %	6.71 %	9.99 %	3.8 %
Return On Equity (Q2 TTM)	16.47 %	14.33 %	19.3 %	13.7 %
Return On Equity 5 Yr. Avg.	19.21 %	20.93 %	17.17 %	10.81 %

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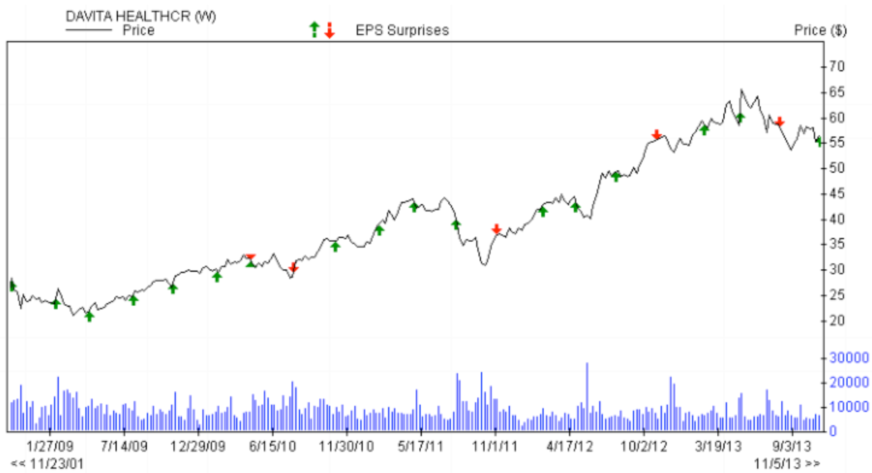
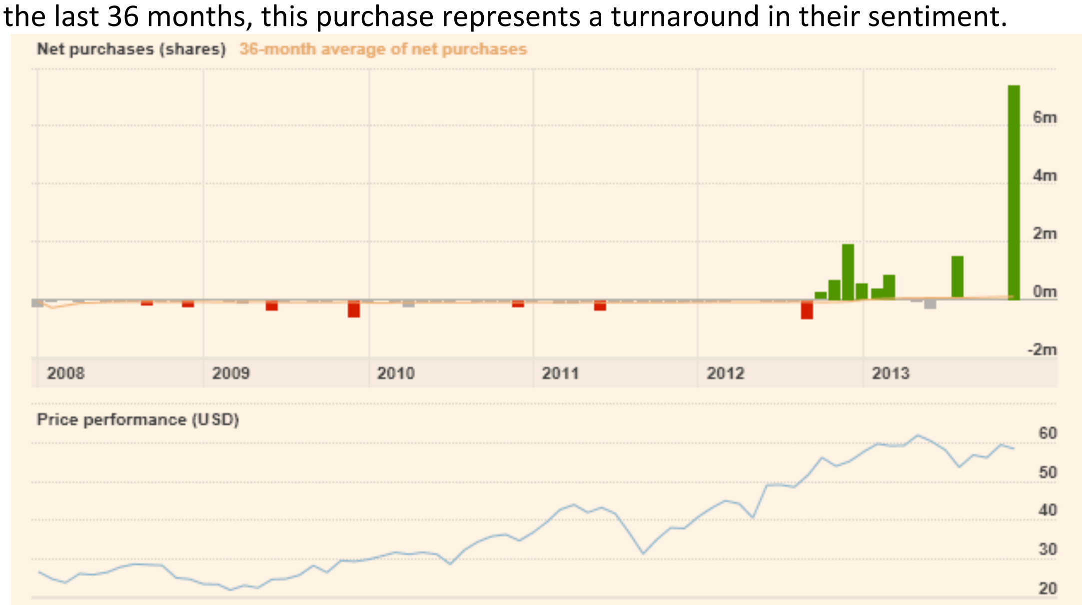
Exhibition4: Fundamental Comparison between DaVita and

	Market Cap	5-Year PEG	Price to Sales (TTM)	Profit Margin	Qty. Earnings Growth	Qty. Revenue Growth
DaVita	$13.09 billion	1.24	1.08	5.16%	(5.60%)	54.20%
Fresenius	$20.78 billion	4.44	1.32	6.91%	1.20%	7.20%
Advantage		DaVita	DaVita	Fresenius	Fresenius	DaVita

Exhibition 5: DaVita always beats the estimated earnings.



Exhibition 6: Recent trading activity by directors implies that they are confident in the company's prospects going forward. In November they purchased a net 7.40m shares. Given that directors have been net sellers on average during each of the last 36 months, this purchase represents a turnaround in their sentiment.



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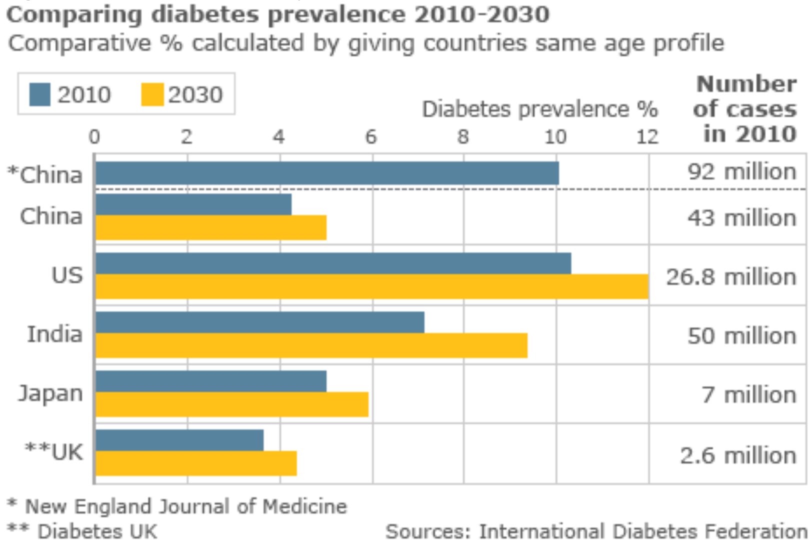
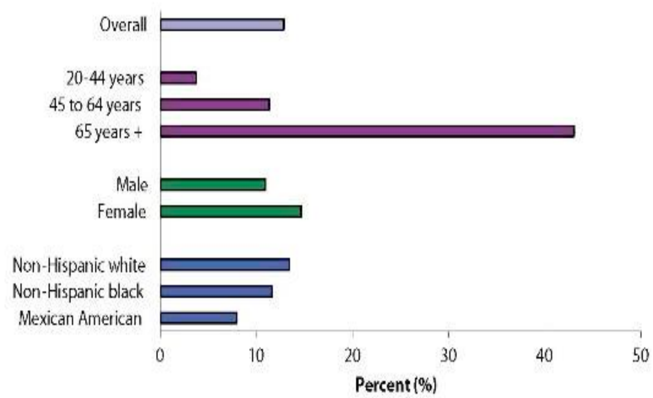
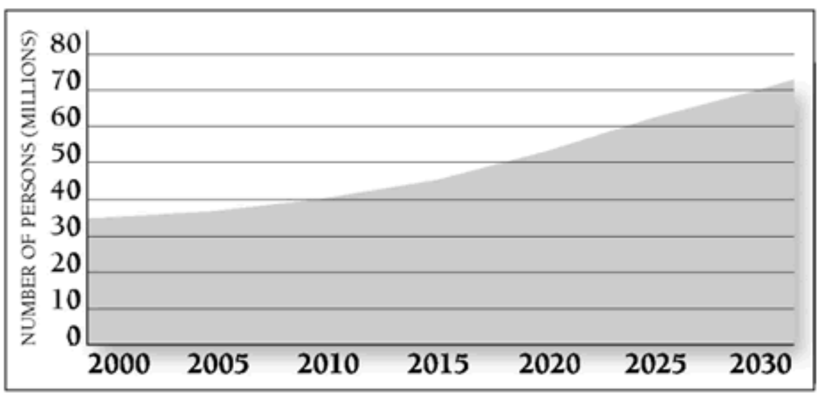
Exhibition 7: Increasing population with Diabetes (Left) and CKD (Chronic Kidney Disease) (Right), which indicates higher demand for dialysis.



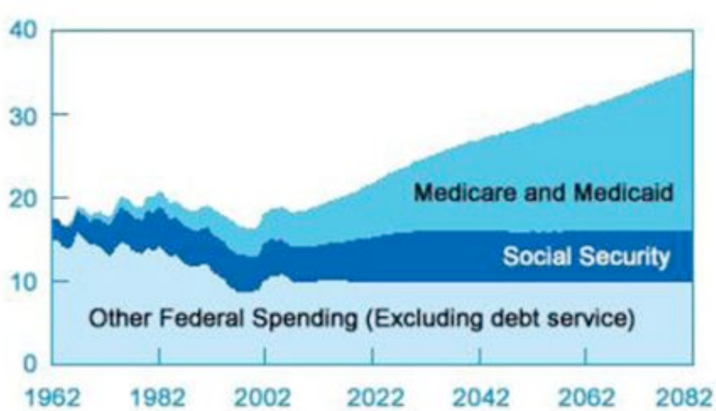


Exhibition 8: Aging Trend in America. The more aged people, the higher the chance of getting kidney disease and diabetes, which further indicate higher demand for dialysis.



Projection of Number of Americans over Age 64 (in millions)
Source: U.S. Census, Population Projections, 2000

Exhibition 9: Projection of Medicare spending in the future (Chart from CMS). Although CMS cut off reimbursement rate for kidney services, in the future, Medicare spending is continuing growing.



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