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DaVita Healthcare Partners: Leading player but too pricey

- DaVita Healthcare Partners (DVA) is a leader in population health or value-based healthcare (capitation) as opposed to fee-for-service healthcare.
- It was initially known as Total Renal Care (TRC), but was restructured and renamed DVA.
- The share price had dipped below $1 in early 2000 and has since risen above $60/share.
- In 2004, DaVita acquired Sweden's Gambro US-based clinics which nearly doubled its outpatient facilities by adding a further 565 clinics to DVA's 664.
- In 2012, it acquired Healthcare Partners (HCP), the managed healthcare provider, and DVA now has two components - Kidney Care and HCP.
- Kidney Care accounts for two-thirds of revenue, and more of profit, while HCP accounts for the remainder.
- In the US, DVA is recognised as a leader in capitation or population health management and with US healthcare needing to move from a wasteful volume-driven fee-for-service system to a value-based one, DVA is well positioned to show attractive volume growth in the years ahead.
- Nevertheless there are problem areas in the business the major one being that the US government is their biggest customer, representing over 60% of revenues. The rates DVA can charge the government is highly regulated and subject to ongoing scrutiny and downward pressure.
- We would argue that despite its solid volume growth outlook, the reliance on the private market to subsidise Medicare patients, makes DVA's Kidney Care an average quality business. If they could make themselves more indispensable by growing their market share, the quality of the business would improve.
- The HCP business is also heavily reliant on the US government for revenues, and is in the storm of Medicare Advantage (MA) programme rate cuts right now. 2014 is a bad year for cuts but we believe 2015 will be less so.
- Thereafter (i.e. 2016 and beyond) rates should settle and HCP will be able to reflect the benefit of good volume growth in its results.
- The attraction in DVA is the pure volume growth in kidney dialysis and the thought leading "population health management" potential of HCP, as well as the excellent management team.
- At its current share price of $66.37, DVA trades on a forward P/E to December 2014 and December 2015 of 18x and 17x, respectively, which doesn't look cheap considering the short-term rate risks.
- Thus for all the complexity and reliance on volume growth to offset rate risk, DVA does not appear to us to be an attractive investment at its current price. However a share price below $60 may be sufficiently attractive.

DVA metrics:

Spot ($)	66.37
Mkt Cap ($bn)	14.2
12M trailing P/E	16.36
12M fwd P/E	18.33
10-year average P/E	17.7
FYE	31-Dec
P/Book	3.21
12M fwd DY	0

Source: Bloomberg, Anchor Capital

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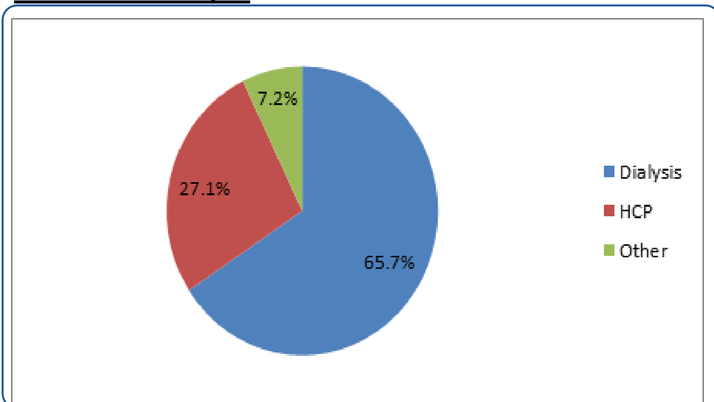
DVA is a leader in population health or value-based healthcare (capitation) as opposed to fee-for-service healthcare. It was initially known as Total Renal Care (TRC). However TRC (a dialysis company), was on the verge of bankruptcy until Kent Thiry joined the company as CEO in 1999. He restructured the business and it was renamed DVA. The successful turnaround that ensued later became a case study at the Stanford Business School. The share price dipped below $1 in early 2000 and has since risen above $60/share. In 2004, DVA acquired Sweden's Gambro US-based clinics which nearly doubled its outpatient facilities by adding a further 565 clinics to DVA's 664. In 2012, DaVita acquired HCP, the managed healthcare provider, for $4.4bn. In September last year the group had a 2 for 1 stock split .

DVA now has two components - Kidney Care and HCP. Kidney Care accounts for two-thirds of revenue, and more of profit, while HCP accounts for the rest.

FY13 revenue split



Source: Company reports

Kidney Care is a chain of dialysis centres where patients with renal failure go, around three times a week, for dialysis. Kidney Care has 34% of the US dialysis market and is the number 2 player in the US. The business has an excellent track record of providing cost effective, high quality renal care. This is a stable business with good organic volume growth (4%-5%). Diabetes and hypertension are the primary causes of kidney failure and these conditions are very prevalent in the African-American, Hispanic and growing elderly populations in the US.

DaVita population health management:

Source: Company presentation

HCP is a physician group in the US (not linked to a hospital group), operating out of five US states, which takes a per-patient per-month fee (i.e. capitation fee) and uses this money to manage the health of a population of almost 800,000 people. It assumes the risk for certain medical bills for this population.

HCP Business Outlook

Source: Company presentation

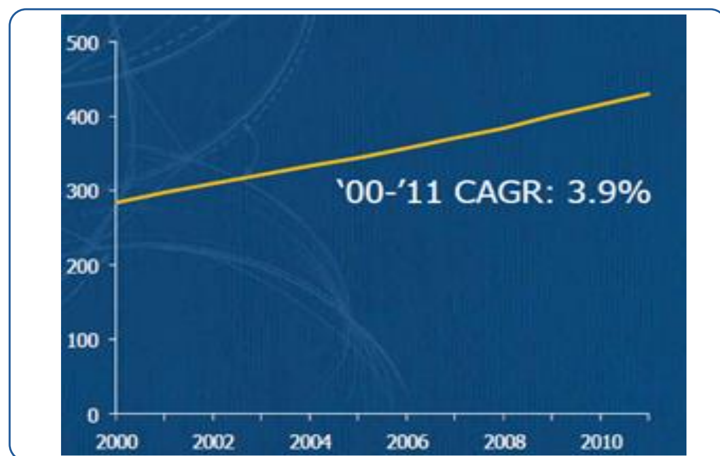
In the US healthcare market where costs are out of control, DVA offers a solution to the cost problem. It is recognised as a leader in capitation or population health management. US healthcare needs to move from a wasteful volume-driven fee-for-service system to a value-based system. DVA is therefore well positioned to show attractive volume growth in the years ahead. The business is also very well managed under respected CEO Kent Thiry.

What are the problem areas?

The major one in our view is that the US government is their biggest customer, representing over 60% of revenues. The rates DVA can charge for these revenues therefore tends to be highly regulated and subject to ongoing scrutiny and downward pressure. Kidney Care has felt this the most and it is in the bizarre position of relying on 10% of their customer base (i.e. private patients) to make a profit. They make a loss from government-sponsored patients (mostly Medicare patients), which account for 90% of the customer base. The good news is that DVA can soon look forward to a more predictable rate environment. As you would expect they have become experts at lobbying the political establishment to protect the rates paid for dialysis. With a 34% market share, they do have some market power with private healthcare insurers. The delayed introduction of President Obama's Affordable Care Act could upset DVA's private customer base but it would be catastrophic for dialysis patients if private rates were lowered and Kidney Care was pushed into losses. Kidney Care margins are reasonable as are its returns on capital. Thus, on balance, we would argue that despite the solid volume growth outlook, the reliance on the private market to subsidise the Medicare patients, makes Kidney Care an average quality business. If they could make themselves more indispensable by growing their overall market share, the quality of the business would improve.

HCP is also heavily reliant on the US government for revenues, with 67% of revenue from the Medicare Advantage (MA) programme alone - a popular subset of the Medicare system that uses capitation rates as opposed to fee-for-service rates. HCP is in the storm of MA rate cuts right now. 2014 is a bad year for cuts (as the chart on the previous page shows) and 2015 will be less so. Thereafter (i.e. 2016 and beyond) rates should settle and HCP will be able to reflect the benefit of good volume growth in its financial results. However, these cuts do mean that HCP margins (on care dollar basis) will drop from 9.3% to 7.2% in 2014, and a little further in 2015.

US dialysis patients ('000):



Source: Company presentation

The attraction in DVA is the pure volume growth in kidney dialysis and the thought leading "population health management" potential of HCP, and the excellent management team. We think rates risks will diminish over the next year and at its current price (of $66.37), DVA trades on a forward P/E to December 2014 and December 2015 of 18x and 17x, respectively. This doesn't look cheap to us considering the short-term rate risks. In addition, DVA does not pay dividends. On a discounted cash flow (DCF) basis, DVA is worth $80/share, 20% higher than the current share price. For all the complexity and reliance on volume growth to offset rate risk, DVA does not appear to be an attractive investment at the current share price. However a share price below $60 may be sufficiently attractive. The share price has recovered from $55 in late 2013.

David Gibb

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