DaVita, Inc. (NYSE: DVA)

Recommend to Buy 5%| PT: $104.31

November 6, 2023

CIMG Investment Research

DaVita: Giving Life in the Village

DaVita (DVA) is a leading medical care facility business that offers comprehensive services to patients suffering from chronic kidney disease (CKD) and end-stage renal disease (ESRD). The onset of ESRD requires patients either receive a kidney transplant or dialysis, which is most commonly where blood is filtered out of the body for the removal of toxins and pumped back in. Despite dialysis being a highly mature industry, DVA has consistently driven impressive sales and earnings growth through acquisitions and share buybacks. As the dialysis industry becomes increasingly consolidated, DVA has expanded into new revenue streams, most notably integrated kidney care. We believe the market is currently undervaluing DVA's stock following trial results of two studies designed to explore the effects of GLP-1 drugs. In addition, we think the market is discounting DVA's stock over fears regarding DVA's commercial payor mix, which represents an outsized portion of operating income. We believe these concerns are overstated as DVA has a tremendous business model predicated on scale and relationships. Additionally, we see multiple near-term catalysts, including a "closed loophole", additional trial result data, and improved margins providing meaningful upside.

Investment Thesis

The Market is Severely Overreacting to GLP-1 Concerns: DaVita's stock price has fallen 31% and 15% since the SELECT and FLOW studies were released August 8th and October 10th, respectively. The FLOW trial was designed by Novo Nordisk to determine kidney outcomes after patients underwent once weekly semaglutide injections. To qualify for the study, patients had to have type II diabetes, chronic kidney disease (CKD), and proteinuria (elevated protein levels in urine). The trial demonstrated that taking GLP-1 drugs led to a later onset for at least one of the following events: kidney failure, initiation of CKR therapy, onset of worsening kidney function, cardiovascular death, and kidney failure death. However, we are confident that extrapolating this data to determine that GLP-1 drugs will have a sizeable impact on dialysis patients is not only a flawed approach but also speculative at this point in time. The highly inclusive criteria used in this study coupled with the significantly higher than average number of patients with high levels of proteinuria in the study (68% of study participants vs. 5-13% typically) limit the application of this data. Additionally, the potential impacts of GLP-1 drugs on dialysis are 10-30 years out given these drugs are most frequently taken by pre-diabetics and early-stage CKD patients still years out from potentially needing dialysis regardless. DaVita estimates that the potential impact of GLP-1 drugs on dialysis patients is ~6%; a number arrived at by taking the product of three estimates: 38% of people are on dialysis from diabetes, there is a 50% likelihood a patient crashes into dialysis, and there is a 33% likelihood a patient uses GLP-1s for the long-term. CIMG takes a more bearish stance on this and estimates that 40% of people are on dialysis from diabetes, there is a 33% likelihood a patient crashes into dialysis, and there is a 50% likelihood a patient uses GLP-1s for the long-term leading to an estimated impact of GLP-1 drugs on dialysis to be ~13%. However, some of the negative impacts to dialysis could be offset by the potential positive impact to dialysis spurred by GLP-1 drugs lowering the percentage of dialysis patients dying from cardiovascular causes.

DVA Operates in a Duopoly that Exhibits Pricing Power and has Proven Resistance to Legal Reform: DaVita is a market winner in an industry that is highly regulated, requires significant upfront investment to enter, and structurally incapable of change due to nationwide partnerships with insurance companies and charitable organizations such as the American Kidney Fund. After decades of tuck-in acquisitions of regional dialysis centers across the US, DaVita is now one of the two largest dialysis providers in the nation and accounts for approximately 40% of the entire market. The dialysis market operates through a system of doctor groups and nephrologists who refer their patients to a dialysis center, and this dialysis center in turn pays the nephrologists a cut of patient earnings. Of 11,000 existing nephrologists in the country, 5,400 commonly refer their patients to DaVita clinics. With medical professionals in their back pocket, DaVita does not have to compete with regional players on the individual patient level or worry about advertising, creating a reliable revenue base that structurally

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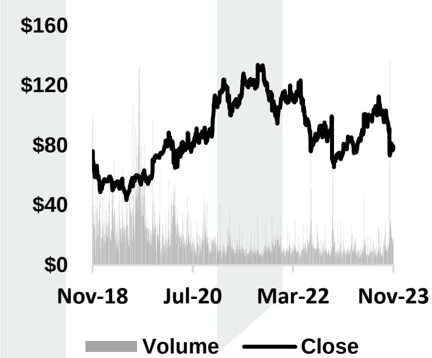
Figure 1: DVA 5-Year Stock Chart



Price	$79.45
PT	$104.31
Dividend Yield	0%
Upside	31.3%
52-Week Range	$65.28-$116.97
Mkt Cap	$7.2B
Ent Value	$18.3B
LTM P/E	15.95x
LTM Price/Sales	0.63x
LTM EV/EBITDA	9.11x
TTM Revenue	$11.74B
EBIT Margin	13.23%

grows with obesity in the US. In addition, DaVita is also able to exhibit pricing power on insurance, because they are essentially forced to partner with DaVita and Fresenius and therefore must pay whatever these two treatment providers dictate, to an extent. In recent years, there has been legislation that attempted to prevent DaVita from dominating the dialysis market so aggressively; however, it did not pass as dialysis is a critical treatment for thousands of Americans and pushback was strong. The California AB 290 Bill is one example: It attempted to prevent the American Kidney Fund from providing benefits to dialysis patients because of its “unfair” partnership with DaVita and insurance companies, but the bill failed to pass. At present, DaVita is both dominant and critical to the dialysis industry and has a considerable amount of leverage over both contracts and regulation.

DVA’s Integrated Kidney Care Segment Will Turn Profitable by 2025/2026: DVA has made a recent push to grow their IKC business due to the rise of the risk-based value treatment model. DVA enters into contracts to provide comprehensive and integrated services, such as healthcare analytics, hospital prevention, patient education, and care coordination to both CKD and ESRD patients in exchange for a share of the savings that they generate for the insurer against a benchmark – a deal that benefits all parties involved. While DaVita faces minimal competition in their traditional U.S. dialysis business, the barriers to entry are much smaller within upstream CKD management; however, we remain confident in DaVita’s ability to be the industry leader due to their existing relationships with providers and nephrologists as well as their demonstrated ESCO savings versus peers in 2019. The revenue model for IKC lags true performance as DaVita can not recognize revenue in the first year as savings are not established. That said, we believe the IKC segment has increasing momentum and will reach a long-term patient under care number around 230,000. With patient growth paired with an average annual savings of $10,500, we believe that IKC will become profitable in late 2025/early 2026 as net savings equates to $3,000 per patient, thus exceeding fixed costs. This, in sum, will drive meaningful topline growth and margin expansion.

Valuation

We arrived at a price target of $104.31 using a discounted cash flow analysis with a discount rate of 10% and a long-term growth rate of -1%. We first modeled out revenue by projecting the total number of U.S. Dialysis patients (accounting for factors such as transplants, GLP-1, and mortality) and multiplying that by our projected revenue per patient which we then divided by market share. We believe that projecting down to this point allows for a more accurate representation of total U.S. Dialysis operations. We believe that the commercial payor mix is not going to shift within the projected future and that revenue per patient will increase by approximately 150bps each year. We also believe that the Integrated Kidney Care segment is going to turn profitable in in late 2025/early 2026 which will push EBIT margin expansion. A long-term growth rate of -1% is suitable for this company as we believe that the progressions made by GLP-1 and other treatments could potentially materially impact the DaVita in the long-term. The combination the -1% LTGR and the 10% DR the upside suggests an upside of 31.29%

Company Overview

DaVita is headquartered in Denver, Colorado, USA. It is a leading provider of kidney care services, primarily specializing in dialysis. The company operates a network of dialysis clinics, providing treatment for patients suffering from end-stage renal disease (ESRD). DaVita's core business revolves around offering dialysis services, managing outpatient treatment centers across the U.S. and globally, focusing on providing essential care to patients with kidney-related health issues. This core revenue segment, known as U.S. Dialysis, accounted for 91% of FY22 revenue. The other 9% of FY22 revenue derived from their ancillary services segment, which includes international dialysis, integrated kidney care, and other support services for patients with kidney diseases. In the U.S. dialysis segment, DaVita primarily focuses on outpatient hemodialysis (80%), home-based treatments (15%), and hospital-based services (5%), generating revenue distribution of 76%, 18%, and 6%, respectively. Ancillary Services, encompassing International Dialysis, constitutes about 6% of revenue, serving 45,600 patients across 350 clinics. With a network of 2,724 clinics across the U.S., DaVita serves nearly 200,000 ESRD patients, while maintaining praise for having the highest-rated distribution of clinics, with 33.2% rated as 5-Star by the CMS (Centers for Medicare and Medicaid Services). DaVita receives a predetermined price per treatment irrespective of associated costs. While the government comprises 67% of the U.S. payer mix by revenue (57% Medicare, 7% Medicaid, and 3% from other programs), on a volume basis, government payors constitute approximately 89-90%, with commercial payors contributing only 10-11%. Despite the dominant role of government payors by volume, commercial payors significantly influence DaVita's income as Medicare and Medicaid rates often fall below the total service costs. Commercial sources account for 33% of the revenue and nearly 100% of the operating income for DaVita.

Industry Overview

DaVita operates in the dialysis treatment industry, which has seen substantial consolidation over the past decade, with the top two dialysis providers accounting for over 80% of US dialysis revenues. DaVita happens to be one of those top two players, along with Fresenius, and these companies use their relationships with both kidney doctors (nephrologists) and insurance companies to capture most dialysis patients while charging high premiums for their services with little to no pushback due to the critical service they provide. Particularly in the US, obesity rates and the number of ESRD patients have increased LSD-MSDs each year since 2001, which is a direct indicator of revenue that can flow through to DaVita. Diabetes is the number one cause for dialysis, and as long as diabetes rates and obesity rates increase, the number of dialysis patients and DaVita’s TAM will ultimately increase in turn. One industry trend that investors are watching is the increasing prevalence of home dialysis. Home dialysis is more convenient for the patient, but many nephrologists are older and reluctant to shift recommendations away from in-center treatment, and insurance benefits also favor receiving dialysis through a center like DaVita.