Intelligent Cloning

The Autumn 2020 edition

"There and Back Again" was a book written by Bilbo Baggins recounting his adventures with Thorin and Company and the quest to reclaim the Dwarf-realm of Erebor. You might argue that the title of this book reflects the financial markets COVID-19 disaster: *"Down 32% and back again."*

I don't recall if Bilbo ever needed any kidney care services, but that is what Davita does, and this stock pick of Berkshire Hathaway's Ted Weschler is probably the most controversial stock in the Intelligent Cloning portfolio. The company is a Fortune 500® health care provider focused on transforming care delivery to patients around the globe. The company is a constituent of the Intelligent Cloning portfolio since 1H '17, and is up 30%. Currently the company trades at a market cap of 10.3B USD and an owners earnings multiple of 8.2. The 2019 net debt relative to owner earnings ratio is 5.5.

DaVita has become a target of prominent short-seller Jim Chanos, the founder of Kynikos Associates, who first spoke publicly about his wager against the company on September 19, 2019, at the Delivering Alpha conference in New York. Was I wrong in copying DaVita from the Berkshire Hathaway portfolio? The Morningstar return on invested capital (ROIC) over the last 5 years doesn't look that impressive either: 3.7%, 8.4%, 7.2%, 3.8% and 8.5%. So let's forget about this shitty company and move forward.

Well… not so fast. During the past 13 years, DaVita's highest return on equity (ROE) was 27.8%. The lowest was 3.8% And the median value was 16.8%. DaVita's ROE is ranked higher than 96% of the 474 companies in the Healthcare Providers & Services industry, according to Gurufocus.com.

Moody's assigned DaVita a "Ba2" credit rating and S&P a "BB" credit rating, both indicating medium credit risk. The Value Firm® Risk Rating is "2", indicating a very low risk of financial distress within two years from now.

And let's have a look at this 12 year chart:

Businesses with a ROC plus the free cash flow margin consistently above the 20% suit me well. DaVita is by no means a shitty company.

DaVita is one of the largest providers of kidney care services in the U.S. and has been a leader in clinical quality and innovation for over 20 years. DaVita is committed to bold, patient-centric care models, implementing the latest technologies and moving toward integrated care offerings. Over the years, they have established a value-based culture with a philosophy of caring that is focused on both their patients and teammates. This culture and philosophy fuels their continuous drive towards achieving their mission to be the provider, partner and employer of choice and fulfilling their vision to "build the greatest healthcare community the world has ever seen."

Revenues

To get a better understanding of the Jim Chanos short, we'll have to dig a little bit deeper into the revenue streams. Kidney failure, also called end-stage renal disease (ESRD), is the last stage of chronic kidney disease. When your kidneys fail, it means they have stopped working well enough for you to survive without dialysis or a kidney transplant. Since 1972, the United States federal government has provided healthcare coverage for ESRD patients under the Medicare ESRD program regardless of age or financial circumstances. ESRD is the first and only disease state eligible for Medicare coverage both for dialysis and dialysis-related services and for all benefits available under the Medicare program. For patients with Medicare coverage, all ESRD payments for dialysis treatments are made under a single bundled payment rate.

Although Medicare reimbursement limits the allowable charge per treatment, it provides industry participants with a relatively predictable and recurring revenue stream for dialysis services provided to patients without commercial insurance. For the year ended December 31, 2019, approximately 90% of DaVita's total dialysis patients were covered under some form of government-based program, with approximately 74% of their dialysis patients covered under Medicare and Medicare-assigned plans.

The short

Now let's try to understand the short thesis. Jim Chanos believes that DaVita is a massive insurance scam. DaVita uses its relationship with the American Kidney Fund — a charitable group that helps people with kidney disease pay for lifesaving care — to profit by moving Medicare patients into more expensive commercial insurance, he argues. The patients are willing to move to commercial insurance because they're told of better services, shorter wait times, and nicer facilities and the charitable American Kidney Fund will pay some to all of the premium tied to the private insurers.

For DaVita and its competitor Fresenius, it's a more profitable way to do business: they charge commercial insurers triple or quadruple what they get from the government's Medicare and Medicaid programs. The two largest donors, at slightly less than 90 percent of the donations to the American Kidney Fund, are DaVita and Fresenius. The concern is that their donations may be keeping people on more expensive forms of insurance so a provider of dialysis can make multiples of what it would otherwise be paid by Medicare for the same level of care.

In May 2019, Blue Cross and Blue Shield of Florida and Health Options — collectively known as Florida Blue — filed a complaint against DaVita for allegedly engaging in a "deceptive and illegal scheme" by making donations to the American Kidney Fund that are then used to buy commercial health insurance coverage for its dialysis patients.

Obviously, DaVita disagrees with Jim Chanos: "Contrary to his claims, charitable assistance is a longstanding financial safety net for a small percentage of kidney care patients who use it to afford their insurance plan, with the majority of patients using it to support their Medicare primary or secondary premiums. This assistance helps ensure they have continuity of care for life-sustaining treatment and access to transplantation."

Davita actually acknowledges that it loses money on patients that use government insurance and makes all its profits from patients using commercial insurance, who are charged substantially higher rates for their dialysis services. Former DaVita CEO Kent Thiry said at the 2017 J.P. Morgan Healthcare conference:

The private payors dramatically subsidize the government. Most of our patients are Medicare. In fact, about 85%, 90% of our patients are from the government sector. On average we lose money on each one, which leads to a grotesquely large cross-subsidy from the private sector to the government.

Thus, the company's profitability largely relies on its mix of commercial versus government payors across its dialysis clinics. DaVita operates in a highly regulated industry. In the healthcare industry, lawsuits are, in a way, "business as usual". Lawsuits and legal proceedings arise due to the nature of its business. The majority of the company's revenues are indeed from government programs and it's pretty obvious that every now and then they may be subject to adjustment by the government. It's just the way it works and if government changes the rules, DaVita will operate by the new rule. DaVita has been tested in the past and they have a track record of successfully battling reimbursement pressures over the past two decades.

But Jim Chanos belives that disruptive proposals could arise from the U.S. presidential election in 2020. "If we get Medicare for All, or a Medicare option, or the Affordable Care Act is shut down due to the federal court ruling, this business model blows up completely." In addition to that, Chanos brought up the facts that DaVita is highly leveraged and repurchasing substantial amounts of stock.

Since 2010 the amount of issued stock decreased with almost 50%. As an investor, I applaud companies that repurchase their stock if done at prices that make sense. And with a 2019 net debt relative to owner earnings ratio 5.5, I would argue that debt is manageable. As far as the political threats are concerned, if all or a substantial part of the company's U.S. commercial patients were to convert to Medicare-level reimbursement rates, its profits would likely drop substantially. To lose all of this business, a Medicare for All requirement that eliminates the private insurance industry would need to be enacted. That's very unlikely to happen. DaVita provides lifesaving healthcare services to chronically ill patients in a low-cost, outpatient setting. I see little likelihood of DaVita faltering due to regulatory disruption in the long term.

Recently though, a new California bill was agreed upon to cap the profits of dialysis providers for more than

3,700 low-income patients in the state, starting in 2022. This bill is known as the Assembly Bill 290. The company may have trouble defending its core revenue should more states follow California's example and cap its profits. But both Davita and Fresenius are strong enough to work its way through it, should the bill succeed. The smaller competition will definitely have more problems surviving in such a new environment, and thus in the long run this Bill 290 actually strengthens the already dominating duopoly of Davita and Fresenius even further.

As a result of the new Assembly Bill 290, the American Kidney Fund said it will be forced to stop providing financial assistance to about 3,700 low-income patients in California when the law goes into effect. Certain provisions of the law will take effect in 2020 while the reimbursement changes go into effect in 2022.

But that scenario just might not happen. Recently, a federal court in California has granted a preliminary injunction to prevent Assembly Bill 290. “Considering both the likelihood that Assembly Bill 290 will abridge plaintiffs’ constitutional rights and the extreme medical risks it poses to thousands of [end-stage renal disease] patients, the court finds it obvious that the public interest favors a preliminary injunction, and that the balance of the hardships tilts strongly in plaintiffs’ favor,” the court said in its ruling.

For now, Davita and Fresenius have the odds on their side. DaVita doesn’t seem shaken by Jim Chanos. Recently, Berkshire sold 2 million shares and now holds 36 million shares of DaVita. With this 29.6% stake, Buffett is still the company's largest guru shareholder. Think about it. Buffett recently sold all of his airplane holdings and (part of his) financial holdings (J.P. Morgan, Wells Fargo, Goldman Sachs, PNC Financial), but he isn’t giving up on Davita. That’s what I call a high conviction holding! Since its low in May 2019 of 43.4 USD, the stock is way up to 84.5 USD as of today. If DaVita was indeed an insurance scam, as Jim Chanos claims it to be, I am quite sure that Warren Buffett, who values business ethics and candor highly, would have sold his entire position to prevent reputational damage for the Berkshire conglomerate.

DaVita is actually fully aligned with the U.S. Government and Health and Human Services Secretary Azar's vision. What Azar's talking about is a focus on outcomes and preventative care and Davita is totally aligned and optimistic and eager to see the details of his plan. Azar's talked about payment reform and regulatory reform, and Davita's been working and giving their feedback and is actually excited to see what the details bring.

“DaVita is encouraged that this administration has taken steps toward holistic, value-based care for kidney patients. We have pushed for progressive policies to give all patients access to integrated kidney care, the benefits of which are significant to our patient population," DaVita CEO Javier Rodriguez said. The constructive relationship Davita has with the U.S. government is, I believe, an important driver for favorable future results.

Industry outlook

The dialysis market size exceeded $80 billion in 2018 and is expected to register more than 4% CAGR from 2019 to 2025. The market will exceed 105B USD after 2025. Dialysis market growth is driven by significant rise in the prevalence of chronic kidney diseases, which in turn has increased patient visits in renal therapy clinics over the last decade. Improved reimbursement policies for renal therapy by private as well as public institutions is boosting the expansion of the market at a remarkable rate.

The market is projected to witness a boost in growth owing to the recent COVID-19 outbreak. The increasing number of patients affected by COVID-19 has led to a rise in the demand for renal equipment, as critically ill patients are experiencing multiple organ failure, including kidney failure. As per National Institutes of Health (NIH), around 5% of the COVID-19 patients are currently experiencing acute kidney injury and would require renal replacement therapy. This scenario has led to an increase in the adoption of renal therapy equipment in hospital settings and is projected to propel the market in coming years.

Growing prevalence of diabetes in developing countries such as India and China due to changing lifestyle and dietary habits will drive the dialysis industry growth. Diabetes interferes with normal kidney functioning and often results in kidney failure. According to the World Health Organization, a large population base in India suffers from diabetic and pre-diabetic condition. Moreover, with an increase in income levels, there is an increase in the standard of living as well as rise in calorie rich food intake, that further escalates risk of diabetes among the population. High blood glucose levels in diabetic patients thus increase the risk of kidney related diseases such as diabetic nephropathy that requires dialysis treatment. Growing prevalence of diabetes associated kidney diseases should prove beneficial for the overall business expansion.

The market size in North America stood at USD 36.5 billion in 2019. North America is projected to dominate the market share during the forecast period. High prevalence of chronic kidney disease and ESRD in the

U.S. and Canada, coupled with higher treatment rates in these countries, are the key factors estimated to boost the expansion of the market during the forecast period. The U.S is also projected to witness growth in the demand for the services and product, attributable to the increasing incidence of coronavirus infections and subsequent renal failures. Europe is expected to emerge as the second-largest region in this market in terms of size, witnessing moderate growth in long-term period. High growth is majorly due to increasing rate of geriatric population suffering from renal disorders in the region.

Asia-Pacific is expected to witness relatively significant growth in terms of value in this market. Funding by public players to improve the accessibility of renal care is likely to augment the expansion of the market during the forecast period. In December 2016, the National Health and Family Planning Commission of China set up the regulations for the basic standard and the management of hemodialysis centers, with an aim to standardize the development of independent such centers in the country. Such established regulatory scenario for renal treatment facilities is projected to boost the expansion of the market in Asia-Pacific.

Competition

The U.S. dialysis industry has experienced some consolidation over the last few years, but remains highly competitive. Patient retention and the continued referrals of patients from referral sources such as hospitals and nephrologists, as well as acquiring or developing new outpatient dialysis centers are some of the important parts of DaVita's growth strategy. In the U.S. dialysis business, DaVita continue to face intense competition from large and medium-sized providers, among others, which compete directly with them for limited acquisition targets, for individual patients who may choose to dialyze with DaVita and for physicians qualified to provide required medical director services. Competition for growth in existing and expanding geographies or areas is intense and is not limited to large competitors with substantial financial resources or established participants in the dialysis space.

Operator	U.S. Market Share
Davita	37%
Fresenius	35%
U.S. Renal Care	3%
Dialysis Clinic	3%
American Renel Associates	3%
Independently owned	11%
All other	7%

DaVita also competes with individual nephrologists, former medical directors or physicians that have opened their own dialysis units or facilities. Moreover, as DaVita continues their international dialysis expansion into various international markets, they face competition from large and medium-sized providers, among others, for acquisition targets as well as physician relationships. Together with their largest competitor, Fresenius Medical Group, they account for approximately 73% of outpatient dialysis centers in the U.S. Many of the centers not owned by DaVita, Fresenius or other large for profit dialysis providers are owned or controlled by hospitals or non-profit organizations.

Fresenius manufactures a full line of dialysis supplies and equipment in addition to owning and operating outpatient dialysis centers worldwide. This may give Fresenius cost advantages over DaVita because of its ability to manufacture its own products or prevent DaVita from accessing existing or new technology on a cost-effective basis. Additionally, Fresenius has been one of DaVita's largest suppliers of dialysis products and equipment over the last several years.

Competitive advantages

Probably the most important part of the investment analysis, and the most difficult one, is identifying durable competitive advantages, also known as "moats". You want to make sure that the company is able to outsmart competition for many years to come.

- The DaVita brand is a compelling one. In 2019 the company has been recognized as one of FORTUNE® Magazine's World's Most Admired Companies of 2019. This is the 12th consecutive year and 13th year overall the company has appeared on this prestigious list. Building such a trustworthy brand in the healthcare industry is very hard and difficult to replicate.

- DaVita has built the largest network of dialysis clinics in the U.S. over several decades, based in part on its compelling brand and reputation for high-quality services, extensive physician relationships, and convenient locations, which all influence the lifeblood of its business--referrals from nephrologists. That's an extremely valuable and hard to replace asset.
- In the Health Care Medical Facilities category, DaVita ranked as the second most innovative company and with their recently unveiled DaVita Venture Group (DVG) well on its way to improve even further. I will come back on this recent initiative in the next chapter.
- High-quality metrics suggesting that other U.S. clinics are having a tough time replicating the service quality that DaVita and Fresenius regularly demonstrate, including hospitalizations, mortality rates, bloodstream infections, and waste removal.
- Scale related factors leading to structural cost advantages and great negotiating power with key players. Both DaVita and Fresenius enjoy stronger negotiating positions than the average U.S. healthcare service provider versus commercial health insurers.
- The average DaVita and Fresenius clinic in the U.S. operates with higher potential capacity, higher utilization, and fewer full-time employees than their smaller peers.

Growth

What I try to do as an investment manager is to identify strong companies, preferable operator owned or family controlled, with exceptional long term growth prospects, and a leadership team, that's able to execute on its strategy and in doing so consistently outsmarts competition. To me, DaVita, although not operator owned or family controlled, is such a company.

DaVita is the largest provider of home dialysis in the country. As of December 31, 2019, DaVita served 206,900 patients at 2,753 outpatient dialysis centers in the United States. The company also operated 259 outpatient dialysis centers in ten countries worldwide. DaVita has reduced hospitalizations, improved mortality, and worked collaboratively to propel the kidney care industry to adopt an equitable and high-quality standard of care for all patients, everywhere.

From 2010 to 2019 the revenue per share grew at 10% per year. But studying past performance is not as important as understanding how a company can create value in the years ahead. DaVita's business model can best be described as a franchise model in the healthcare industry. There is still plenty of room to grow, both nationally as internationally, as in terms of further healthcare services diversification. DaVita continues striving to align itself with the evolving path of the nation's healthcare system.

As part of its continued efforts to further transform patient care, DaVita recently unveiled DaVita Venture Group (DVG). This incubator group plans to accelerate DaVita's efforts to develop and deploy solutions that are designed to improve the health care and quality of life for people with kidney disease and related chronic conditions.

"Innovation should never stop when there is an opportunity to improve patient care," said Javier Rodriguez, CEO of DaVita. "We want to transform kidney health – from chronic kidney disease to transplant – and we're putting financial and strategic resources into these solutions. We believe we can be the partner of choice for entrepreneurs who want to bring best in class technology and innovations to market."

Bringing patient-centered chronic care to scale requires reimagining health care as it exists today. A typical patient with end-stage kidney disease is high-risk and high-need. They often have four or more comorbidities and spend approximately 11 days in the hospital each year. With a focus on broadening innovation across the continuum, DVG aims to expand access to care and improve clinical outcomes while also increasing the adoption of value-based care to reduce costs.

I do expect Davita to be a global and leading next-generation healthcare company with a strong focus on innovation and new services, such as:

- Home Remote Monitoring captures and wirelessly transmits patients' biometrics to the care team for proactive intervention.
- Care Connect App enhances patient engagement through features such as secure messaging, care reminders and access to educational resources.
- Telehealth visits enabled through multi-way video conferencing capability.
- Health Management Navigator provides advanced training to DaVita nurses so they can more effectively manage patients with comorbidities.
- Predictive Modeling helps identify Home dialysis patients most at risk for adverse events so that early intervention can take place.

So here we are

Ted Weschler owned DaVita since at least 2001. Before going to Berkshire, Ted Weschler ran a hedge fund called Peninsula Capital. DaVita was one of Peninsula Capitals largest positions from 2001 through 2011. In June 2001, Peninsula had $71 million of its $239 million portfolio (30%) invested in DaVita. And at almost all times between 2001 and 2011, Peninsula had between 20% and 40% of its portfolio in DaVita.

What I learned over many years of investing is that it makes a lot of sense to try to catch these exceptional companies early in their competitive lifecycle, when they are still small. In 2001 you could have bought Davita stock for 6 USD. Nowadays it's trading at 84.5 USD. That's a 14 bagger. I like 14 baggers! As long as Berkshire holds on to the company, I will. Unless... unless I find an even better opportunity.

Peter

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Post scriptum.

- Liberty Global was removed from the Intelligent Cloning portfolio (+5%) and replaced by XPEL @15 USD.
- Kudos for this write-up go to Christine Idzelis, who published "Berkshire Hathaway Bet Big on Dialysis Giant DaVita. Jim Chanos Thinks It's a Scam", to Julie Utterback who published "DaVita Remains an Essential Business in Any Environment", to Jack Strole, who published several write-ups on Davita and to Global Market Insights for the Industry Outlook data.

During the due diligence I gather a lot of free available information on the web and then try to "connect the dots". I try to refer to the original authors and documents where necessary, but that's not always doable. If I forgot to mention you, just let me know and I will add you anyhow. Everybody makes mistakes now and then. If you find any, let me know: peter@thevaluefirm.com. Always do your own research!

Thanks for reading!