DaVita Inc. (DVA)

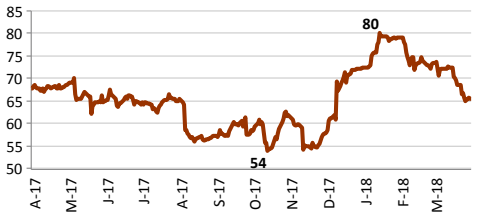
There Is Science, Logic, Reason...and then There Is California

Reiterate Outperform rating. DVA's stock has underperformed for two primary reasons. One, the market is concerned with the DMG deal. Two, investors are increasingly worried about the SEIU's California ballot initiative. We'll argue the stock is pricing in an 80%-200% probability that the SEIU's "efforts" are successful. This strikes us as an implausible outcome. Squared against a deeply discounted valuation, pathway towards visibility, and what we view as an extremely compelling risk/reward (arguably 3:1), we find the set-up compelling at current levels. DVA has now round-tripped its DMG sale announcement.

- **Collective bargaining the clear goal.** The SEIU is clearly using a dual-track strategy with a ballot initiative (caps commercial reimbursement at 115% of service costs) and legislation (mandatory dialysis staffing ratios) to gain leverage on the dialysis industry. The end goal is to organize dialysis workers and collectively bargain.
- **Ballot initiative could have momentum.** Press reports indicate the union has already gathered enough signatures to get the initiative onto the ballot. Our industry contacts note that CA has shifted noticeably left in reaction to events in D.C. and as a result expects high Democrat voter turnout. However, we note that most of the SEIU's past initiatives have never made it all the way to the ballot (reach agreements with targeted providers) or have usually failed in the general election.
- **Legislation is more likely.** Given the less costly/more flexible nature of legislation, our sources believe the SEIU is likely to focus its efforts on this avenue. The vote count within the CA Assembly is fuzzy (already passed CA Senate), but the governor's office is likely the largest obstacle to passage. Our sources believe the governor is not inclined to sign the bill.
- **Industry well-positioned with options.** The industry has robust lobbying capabilities in Sacramento and our sources indicate state legislators are experiencing "dialysis fatigue." The SEIU is also pursuing a number of non-dialysis initiatives this election cycle and has a primary focus on helping its favored candidate for governor win election, therefore constraining the organization's resources. The industry has a much larger war chest for fighting a state-wide initiative while it could also propose its own (industry standard) staffing ratios to appease legislators and derail the SEIU's dual-track strategy.
- **Sizing the potential impact.** We think the most likely outcome is that DVA/FMS either defeat the SEIUs initiatives, challenge successful passage of them in court, or come to some form of agreement with the union. However, should the worse come to pass, we have sized the impact of the mandatory staffing bill at roughly $100m-$150m while the ballot initiative would likely force DVA to walk away from CA altogether ($300m+).

RESEARCH UPDATE

1-Year Price Chart



Stock Data

Rating:	Outperform
Suitability:	Average Risk
Price Target:	$97
Price (3/27/18):	$65.34
Market Cap (mil):	$12,075
Shares Out (mil):	184.8
Average Daily Vol (mil):	1.51
Dividend Yield:	0.0%

Estimates

FY Dec	2017A	2018E	2019E
Q1	0.79 A	0.94 E	1.35 E
Q2	0.92 A	0.96 E	1.49 E
Q3	0.81 A	1.11 E	1.61 E
Q4	0.92 A	1.19 E	1.64 E
Fiscal EPS	**3.44 A**	**4.20 E**	**6.09 E**
Fiscal P/E	19.0x	15.6x	10.7x

Chart/Table Sources: FactSet and Baird Data. Price chart reflects most recent closing price.

EPS (Net): Represents "cash" EPS excluding HCP acquired intangibles

Please refer to Appendix - Important Disclosures and Analyst Certification

DVA is a leading provider of dialysis and physician integrated care services.

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Details

Weighing in on the California Debate

- **Background.** The SEIU is using a dual-track strategy in the California legislature and the state ballot box to gain leverage in efforts to organize workers within the dialysis industry. Last winter the SEIU began the process of gathering signatures for a ballot initiative to cap dialysis clinic reimbursement on commercial patients at 115% of "direct patient service costs." Last summer, the union also attempted to push through legislation mandating the strictest patient staffing ratios in the country for dialysis clinics. The legislation was stayed in the fall, but the ballot initiative process is ongoing.

- **Mandatory staffing ratio legislation is likely the union's preferred option.** The staffing ratio bill (SB 349) currently is inactive on the CA Assembly floor and can be brought up for a vote or amendments at any point during the current legislative session which ends August 31. Our sources indicate a fuzzy vote count with political operatives on both sides optimistic on their chances of success. The governor's office presents another challenge for the legislation and our sources believe Jerry Brown is not inclined to sign the bill in its current form. The governor is not focused on healthcare policy and has historically avoided unnecessary encumbrance on regulatory agencies, especially the CA Department of Health, which is already behind on developing healthcare regulations.

- **Ballot initiative risk still exists.** Our sources believe it is likely that the SEIU has collected enough signatures, and will likely submit on April 11 to get the commercial reimbursement cap initiative on the ballot. Historically the SEIU has used ballot initiatives as leverage given their costliness, dubious track record (five losses in last seven attempts), and the sheer granularity of the proposal could make it difficult to organize the electorate. However, our sources note that events in Washington D.C. have pushed the CA political environment further left, political operatives are expecting a large Democratic turnout in the November 2018 elections, and traditional knowledge/expectations ought to be re-inventoried in the new climate. It is possible for a corporate profiteering pitch to gain more traction than expected in CA in the upcoming election cycle.

- **Governor primary results could mitigate ballot initiative risk.** Our sources pointed to the CA governor's race as an event that will influence the SEIU's ability to take the dialysis initiative all the way to the ballot box. A primary outcome that leaves two Democrats running for governor would force the SEIU to allocate significant funds toward the November 2018 election to support their preferred candidate. However, if a Republican makes it through the primary and onto the final ballot, the November race will be very one-sided in favor of the Democrats and the SEIU would have more funds to allocate toward pushing their dialysis ballot initiative. Democrats Villaraigosa and Newsom currently lead polling at 23% and 21% respectively, and we believe the high likelihood of an all-blue ticket is positive for the industry. The primary will take place on June 5.

- **Industry is well-positioned and tuned into the situation.** The industry effectively organized last fall to stay the staffing ratio bill, and CA legislators have felt some dialysis "fatigue" over the last several months given the industry's strong advocacy efforts. Our sources indicated that while the industry has been comfortable since their victory, they will likely begin taking a closer look at approaching risks and plan accordingly in the coming months. Given the cost of a ballot initiative and the governor's race dynamics, it seems more likely that the situation is settled either in the legislature or at the negotiating table. One potential outcome we think may not be garnering enough consideration from investors is the prospect for the industry to propose its own staffing ratios closer to the industry standard to appease legislators and reduce the SEIU's leverage.

- **Key dates.** April 11 (Ballot initiative signature submission deadline); June 5 (CA gubernatorial primary results); August 31 (CA legislative session end); November 6 (2018 elections and ballot initiative).

- **Worst case scenario.** We believe that the worst case scenario (passing the ballot initiative) would be so devastating (~$450m) that DVA would likely walk away from the state all together given its profits would be more than wiped out. While we don't think this will ever occur given that it would lead to the majority of all dialysis clinics in California closing and force these patients into hospital ERs three times a week, we present our

analysis of the financial impact on the following page. Similarly, we estimate that the mandatory staffing legislation would represent a ~$100-$150m increase in costs), but think DVA would still be able to profitably operate clinics in the state. We think it is much more likely that the union's initiatives are defeated or that the industry reaches some form of a détente with the SEIU.

Figure 1: Mandatory Staffing Legislation Impact

Current Median Staffing Ratios

	Median Patients Per *(a)*	# Required per Clinic *(b)*	Hourly Wage *(c)*	Total Hours *(d)*	Total Salaries	Tax/Benefit Costs *(e)*	Total Employee Cost
RN	18.5	1.0	$ 32	3,038	$ 97,224	$ 29,167	$ 126,391
Dialysis Tech	11.1	1.6	16	5,066	81,050	24,315	105,365
Social worker	82.0	1.3	30	2,741	82,218	24,665	106,884
Dietitian	82.0	1.3	30	2,741	82,218	24,665	106,884
				Total cost of regulated positions/clinic:			**$ 445,524**

a) DVA's 2009 median staffing levels per https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3840051/table/T3/

b) Assumes 18 dialysis stations/clinic and 108 patients/clinic/week

c) Baird estimate based on information from Glassdoor

d) Assumes clinics are open 10 hours/day, 6 days/week. Social workers and dieticians work 40 hours per week.

e) Assumes non-salary costs are 30% of base salary

Current Mean Staffing Ratios

	Mean Patients Per *(a)*	# Required per Clinic *(b)*	Hourly Wage *(c)*	Total Hours *(d)*	Total Salaries	Tax/Benefit Costs *(e)*	Total Employee Cost
RN	15.2	1.2	$ 32	3,684	$ 117,891	$ 35,367	$ 153,258
Dialysis Tech	10.6	1.7	16	5,279	84,465	25,339	109,804
Social worker	56.2	1.9	30	3,999	119,958	35,987	155,945
Dietitian	56.5	1.9	30	3,976	119,284	35,785	155,069
				Total cost of regulated positions/clinic:			**$ 574,077**

a) DVA's 2009 mean staffing levels per https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3840051/table/T3/

b) Assumes 18 dialysis stations/clinic and 108 patients/clinic/week

c) Baird estimate based on information from Glassdoor

d) Assumes clinics are open 10 hours/day, 6 days/week. Social workers and dieticians work 40 hours per week.

e) Assumes non-salary costs are 30% of base salary

Proposed Staffing Ratios

	Mandatory Patients Per *(a)*	# Required per Clinic *(b)*	Hourly Wage *(c)*	Total Hours *(d)*	Total Salaries	Tax/Benefit Costs *(e)*	Total Employee Cost
RN	8.0	2.3	$ 32	7,371	$ 235,872	$ 70,762	$ 306,634
Dialysis Tech	3.0	6.0	16	19,656	314,496	94,349	408,845
Social worker	75.0	1.4	30	2,995	89,856	26,957	116,813
Dietitian	75.0	1.4	30	2,995	89,856	26,957	116,813
				Total cost of regulated positions/clinic:			**$ 949,104**

a) As required by proposed CA statute

b) Assumes 18 dialysis stations/clinic and 108 patients/clinic/week

c) Baird estimate based on information from Glassdoor

d) Assumes clinics open 10.5 hours/day, 6 days/week (bill requires 45 min. transition time between patients). Social workers/dietitians work 40 hours/week

e) Assumes non-salary costs are 30% of base salary

Source: Baird, Company Reports, Glassdoor, NIH, USRDS

Figure 2: Mandatory Staffing Ratio Legislation Impact

New cost of regulated positions per clinic	$	949,104
Mean cost of regulated positions per clinic		574,077
Median cost of regulated positions per clinic		445,524
Increased cost per clinic vs. mean		375,027
Increased cost per clinic vs. median		503,580
# of clinics in CA		283
Increased cost to DVA (vs. mean)		**$ 106,132,781**
Increased cost to DVA (vs. median)		**$ 142,513,135**

Source: Baird, Company Reports

Figure 3: Ballot Initiative Impact

Commercial revenue	$	3,438
Commercial Tx (000s)		3,232
Current commercial rev/tx	$	1,064
Patient care costs/Tx (2017 avg)	$	224
G&A costs/Tx (est. 50% qualifies)		13
D&A cost/Tx		18
Total cost/Tx	$	256
115% of total cost per Tx	$	294
Current commercial rev/Tx		1,064
Change in commerical rev/Tx	**$**	**(769)**
Commercial Tx in CA (18% of total)		582
Reduction in commercial revs	**$**	**(447,671,785)**
Est. total EBIT generated in CA	$	318,240,000

Source: Baird, Company Reports

- **DVA's recent valuation decline implies an ~80% probability it walks away from CA altogether.** DVA's share price has declined by nearly $8 since the time we believe the risks surrounding the union initiatives in California entered the forefront of investor's minds (January/February). Prior to the concerns introduced by this risk factor, DVA commanded an 8.4x EV/EBITDA multiple on our 2019 estimate. If we assume the vast majority of the decline in DVA's share price is due to the risks presented by California and hold the "pre-CA" EV/EBITDA multiple of 8.4x constant, the $8 decline in DVA's share price ($2.1b enterprise value decline) implies a $252m reduction in DVA's 2019 EBITDA. This is in comparison to our estimated $124.3m impact (at the midpoint of our two scenarios) from passing the mandatory staffing ratio legislation, implying a 203% probability that this event actually occurs. Similarly, we estimated the impact of the ballot initiative capping margins on commercial patients to be $318m (assuming DVA exits CA and doesn't incur losses). The $252m reduction in DVA's EBITDA implied by recent share price declines would suggest a 79% chance of this scenario playing out. Clearly the recent sell-off is more than overdone.

Figure 4: Implied Probabilities of CA Risks Coming to Fruition

Share Price: Pre-CA	$ 77.00
Implied EV	$ 17,934.1
2019 EV/EBITDA	8.4x
Share Price: 3/27/18	$ 65.34
Implied EV	$ 15,806.6
Decline in EV	$ (2,127.5)
EV/EBITDA Pre-CA	8.4x
Implied EBITDA Loss	**$ (252.0)**
Est. Staffing Ratio Impact (mid pt.)	$ 124.3
Implied likelihood of occurrence	203%
Est. Ballot Initiative Impact	$ 318.2
Implied likelihood of occurrence	79%

Source: Baird, Company Reports

Investment Thesis

Our rating on DaVita (DVA) is Outperform. We have a favorable long-term sector view on dialysis underpinned by: (1) inelastic demand for services, with life-saving characteristics; (2) long-term ESA/therapy cost savings opportunities; (3) out-year Medicare Advantage enrollment tailwinds (2021+); and (4) our belief that dialysis providers, including DVA are tethered to numerous integrated care growth opportunities over time.

Four key reasons underpin our near-term thesis: (1) we see diminishing risk factors in the context of charitable premium assistance; (2) 2019 Street estimates look too low and investors could be overlooking an improved Medicare rate backdrop; (3) tax reform sets up meaningful upside and we see north of a 9% FCF yield on 2019 with an unsustainably low 10x-11x P/E multiple and (4) DVA could have to retire nearly 40%+ of the company's non-Berkshire float over the next 2 years.

Valuation and price target. Our $97 price target is based on an 16x multiple applied to our 2019 EPS estimate, in line with the forward one-year average given diminished risk surrounding premium assistance and meaningful capital deployment opportunities.

Risks & Caveats

Our suitability rating on DVA is Average Risk based on consistent historical performance, recurring and defensive nature of dialysis services, consistent volume growth, and moderate balance sheet leverage.

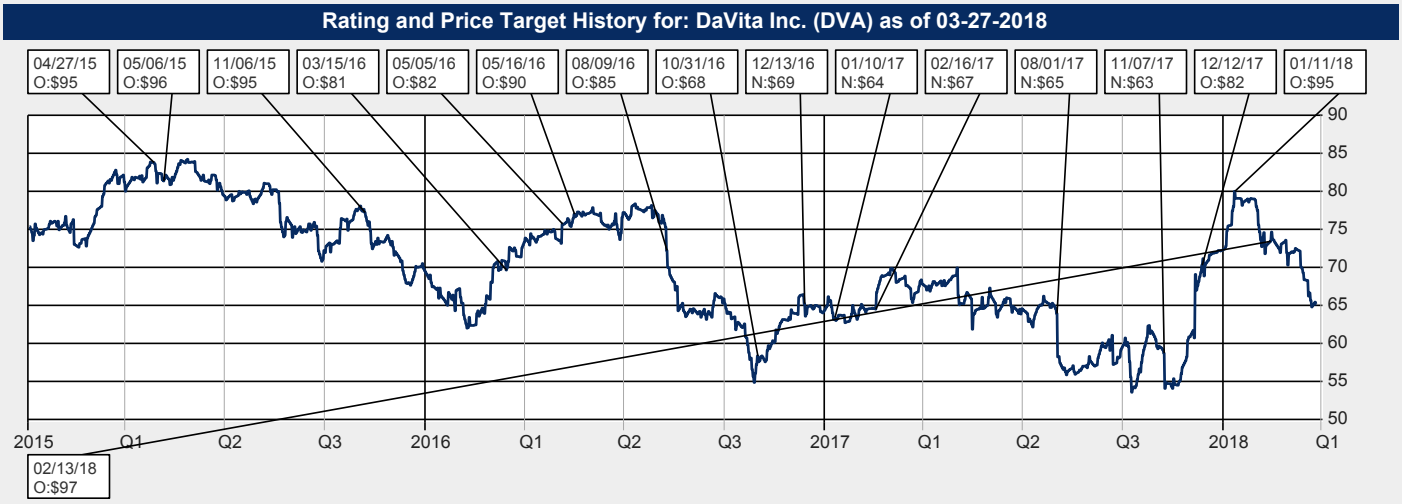
Key risks include:

- **Government reimbursement risks.** DVA generates approximately 65% of its dialysis revenues from governmental sources, including Medicare and Medicaid, subjecting the company to changing political, economic and regulatory influences.
- **Government investigations and inquiries.** DVA is subject to numerous ongoing government investigations and inquiries, similar to most large-scale, high-profile Medicare providers. An adverse outcome from any of these inquiries could have a negative impact on DVA.
- **Commercial pricing risks.** DVA generates most of its dialysis operating profit from commercial payers, representing 13% of patients and 35% of revenues. A change in commercial pricing levels could have a significant impact on DVA's profitability and cash flow.
- **Levered balance sheet.** DVA is currently levered near 3.5x debt-to-EBITDA, generally in line with historical levels and healthcare facility peers. DVA's external and internal growth is dependent in part on accessing the capital markets. The inability to issue debt or equity capital could have an adverse impact.
- **Other risks.** Other risks include labor shortages, natural disasters, market concentrations, and HCP.

Company Description

DaVita (DVA) is a leading provider of (1) dialysis services to patients suffering from end stage renal disease (ESRD) and (2) integrated primary care services. DVA operates more than 2,200 outpatient dialysis clinics located in ~45 states and serves more than 180,000 patients. DVA's DaVita Medical Group segment provides primary care services through its ~2,800 IPA primary care physicians, primarily through risk-sharing arrangements including global capitation (~2.2M member months).

Appendix - Important Disclosures and Analyst Certification



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