

# DaVita Inc. (DVA)

## CA Governor Vetoes SB 1156, Adding Positive Fresh Pick

**Maintain Outperform rating.** We are adding DVA as a positive Fresh Pick following the veto of California Senate Bill 1156. While most expected CA's Governor to veto SB 1156, this does remove a key industry overhang and we think several other catalysts could push the stock higher into year-end: (1) Prop 8 failure on November 6; (2) Close of DMG sale; (3) Progress with the PATIENTS Act. The unions may continue to target the dialysis industry in the future, but key risks are fading for now.

- California Governor vetoes SB 1156.** Over the weekend, California Governor Jerry Brown vetoed SB 1156, which would have reduced reimbursement for commercial patients receiving charitable premium assistance beginning in 2019. We had estimated the gross EBITDA risk for DVA near \$100M (before cost offsets). In our view, a veto of SB 1156 was mostly reflected in investor expectations, as our lobby contacts (and others') previously suggested the governor was likely to veto the bill. We view the veto as a modest positive for DVA.
- Focus now on Proposition 8, but also seems unlikely to pass.** We believe investor focus will now shift to Prop 8, a union-backed ballot initiative that would significantly reduce reimbursement for all commercial patients in California. Voters will consider Prop 8 on November 6 and we previously estimated the gross EBITDA risk near \$400M. We think it's unlikely Prop 8 will succeed for several reasons: (1) DVA (and FMS) have more resources than the SEIU; (2) the SEIU has been unsuccessful with ballot initiatives in the past; (3) Prop 8 is complex and is less relevant to the average voter.
- Adding DVA as positive Fresh Pick given multiple pending catalysts.** We see several positive catalysts that could push DVA's stock higher into year-end. (1) As mentioned, we expect Proposition 8 will not be approved by California voters on November 6. (2) The CBO may provide a score for the PATIENTS Act over the next several weeks (per industry advocates); this legislation would integrate health and kidney care and would be positive for DVA. (3) The \$4.9B sale of DMG should close before year-end, with proceeds primarily going towards buybacks (will also normalize valuation calcs for Bloomberg, FactSet, etc.)

**FRESH PICK**

EXP: 12/31/18

**RESEARCH UPDATE**

### 1-Year Price Chart



### Stock Data

Rating:	Outperform
Suitability:	Average Risk
Price Target:	\$90
Price (9/28/18):	\$71.63
Market Cap (mil):	\$12,471
Shares Out (mil):	174.1
Average Daily Vol (mil):	1.30
Dividend Yield:	0.0%

### Estimates

FY Dec	2017A	2018E	2019E
Q1	0.79 A	1.05 A	1.15 E
Q2	0.92 A	1.05 A	1.25 E
Q3	0.81 A	0.92 E	1.30 E
Q4	0.92 A	0.99 E	1.30 E
<b>Fiscal EPS</b>	<b>3.44 A</b>	<b>4.02 E</b>	<b>5.01 E</b>
Fiscal P/E	20.8x	17.8x	14.3x

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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## 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.

**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) DVA could have to retire nearly 40%+ of the company's non-Berkshire float over the next 2 years.

**Valuation and price target.** Our \$90 price target is based on an ~9.5x EV/EBITDA multiple applied to our 2018 estimate, towards the high end of the company's historical 8-10x trading range reflecting optionality around capital deployment (esp. buybacks).

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## 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.

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## 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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