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What Investors Should Know Before Acquiring a Dialysis Center

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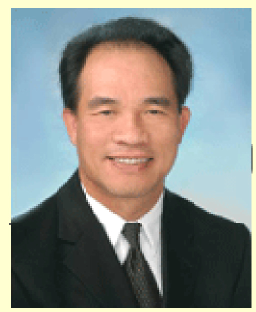

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Who Needs Dialysis Centers?

Kidney dialysis is a life support treatment for patients with end-stage kidney disease or kidney failure. For these patients, their kidneys either do not work properly or not at all. They experience a buildup of waste in their blood. Without dialysis, the amount of waste products in the blood would increase and eventually reach levels that would cause coma and death. Kidney disease is mainly caused by diabetes (44% the cases), and high blood pressure (25% of the cases). There are over 600,000 patients in the US that need dialysis services. 90% of them are over 60 years old. The US population is getting older and older every year. More people also have diabetes. Per Centers for Disease Control and Prevention (CDC) the US currently has over 29 million diabetic patients: 21 million diagnosed and over 8 million undiagnosed with 1.7 million new diabetes cases every year. Some of these patients will eventually need kidney dialysis. There are 2 solutions for these patients:

1. Kidney transplant: This is the permanent solution. While it's the best option, the supplied of kidneys are very limited with average wait time of 3 years. There are just over 20,000 kidney transplants a year.
2. Kidney dialysis: they need to come to dialysis centers 3 times a week and hook up to artificial kidney machine (assuming hemodialysis) to filter harmful wastes, salt, and excess fluid from their blood.

93 percent of dialysis patients prefer to go to the dialysis centers for treatment. Only 7 percent receive peritoneal dialysis and about 1% choose home hemodialysis which requires a home dialysis machine at home, e.g. machine made by NxStage Medical. And so dialysis centers will be here to stay. Since it's a life support treatment, kidney dialysis expenses are reimbursed either by health insurance or by government. The tenant in turn has money to punctually pays rent to the landlord. From an investment viewpoint, dialysis centers are a stable investment as there is a growing need for them.

Major Dialysis Clinics

The 5 largest dialysis clinic chains in 2015 are:

Dialysis Chain	Patients	Centers	Patients/Center
Fresenius Medicare Care N.A.	178,337	2312	77
Davita Kidney Care	174,300	2173	80
US Renal Care	16,050	274	58
Dialysis Clinic Inc.	14,800	233	63
American Renal Associates	12,250	184	66

In the last 10 years, both Fresenius (S&P BBB-) and Davita (S&P BB-) grew mainly through acquisition of smaller chains. In August 2015, DaVita paid $416M for Renal Ventures with 36 dialysis centers ($11.555M/location). This is the main reason you often don't see Fresenius or DaVita as the tenant in the leases. The pace of acquisition is expected to stop or slow down in the future as both face antitrust concern from the Federal Trade Commission. Both Fresenius and DaVita borrowed money to finance these acquisitions. Fresenius had $16B in debt as of September 2014 and DaVita had $9.1B as of June 2015. Due to large amount of debts, both Fresenius and DaVita don't have strong credit ratings. However, their businesses are profitable. DaVita reported $6.722B in the first 6 months of 2015 and $168M in income before taxes. (Note: DaVita reported $4.635B in patient services revenue and $1.176B in capitated revenue in the first 6 months of 2015. This means DaVita receives an average of over $70,000 in revenue per patient.) Fresenius reported $10.B in revenue 2014 and $1.643B in Operating Income for North America.

Typical Dialysis Center

A typical center is a free-standing single-story medical office building 7000-15000 SF in size with a canopy at the front entrance. It has 16-36 dialysis station, opens 12 hours/day, 6 days/week. Most patients come to the center by appointments 3 times a week either M-W-F or T-Th-S with each session about 4 hours long. The busiest locations open 24 hours/day.

Which Dialysis Center Is Best For You?

A brand new dialysis center typical has a 10-15 years NNN lease and offers 5-6% cap with some landlord responsibilities. It normally offers annual rent bumps or 10-15% rent bumps every 5 years. The tenant also has several 5-year options. So compared with ground leases for brand name fast food restaurants, dialysis centers offer better cap for investors. When the lease has 2 years left, the cap often increases to 7.5 to 8.5% cap as most investors are concerned the tenants may not renew. So if you can pick a dialysis centers with 1-2 years left on the lease, knowing it will renew later then you find a winning formula of getting good returns for your investment.

1. The odds are in your favor as tenants seldom close or move. The tenants spend lots of money on build out, installing dialysis machines and water filtration systems. To move the business to a new location, the tenant needs to set up a duplicate dialysis center at the new location while operating the existing one. And so moving is very hard for the tenant to justify from a business viewpoint. The author is aware of only 2 centers having to close down: one for being too dilapidated, i.e. unsafe, and the other as a result of having 2 centers too close together after an acquisition of a dialysis chain.

2. Acquire a busy location. There are main 3 factors that determine a busy location:

- Number of patients: if the Fresenius center you plan to acquire has 110 patients then it has 33 more patients than the average of 77. With each patient generating over $70,000 in revenue, this center has annual revenue of $7.7M/year. It's a good sign if the rent to revenue ratio is below 3%.
- Occupancy rate. This is somewhat similar to the hotel occupancy rate. So the higher the number the better it is with 70% or higher is considered strong. It shows the percentage of dialysis machines generating income during business hours. The occupancy rate is the obtain by dividing the number of patients to the patients capacity of the center. If a center has 24 dialysis machines, opens 6 days/week and 12 hours/day then its capacity is (24x3x2)=144 patients (since each machine can serve 3 patients in 12 hours as each procedure lasts 4 hours and each patient needs machine 3 times/week). So if the center has 110 patients, it is operating at 76.38% of its capacity which is also a strong figure.
- Number of Open Hours: the more hours the center open, the least effective rent it pays. For example the 24-hour location in effect pays 1/2 the rent compared to a location opens 12 hours/day. The 24 hour location can also maximize the money invested in dialysis machines. However the 24 hour location incurs higher labor costs so a location is only open 24 hours/day if there are enough patients to justify for it. On the other hand, there are some dialysis centers that open only 3 days/week. You should think twice before acquiring this location.

Among all the racial and ethnic groups aged 20 or older, American Indians/Alaska Natives have highest diabetes rate of 15.9%, Blacks 13.2%, Hispanics 12.8%, Asian American 9% and Non-hispanic White 7.6%. Areas with high concentration of senior citizens should have more dialysis patients. So reviewing demographics data to have an idea about the potential number of patients. Please also refer to the article "What You Should Do During Due Diligence Period" for additional information about due diligence investigation for all commercial properties.