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What Investors Should Know Before Acquiring a Dialysis Center

By David V. Tran

Who Needs Dialysis Centers?

Kidney dialysis is a life support treatment for patients with end-stage renal disease (ESRD) or kidney failure. These patients lose at least 85%-90% of kidney function. 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 746,557 ESRD patients in 2017 (727,9912 in 2016) in the US that need dialysis services. The number of patients grow about 2.6% a year. 90% of them are over 60 years old and about 525,000 of them are covered by Medicare in 2015. While the number of ESRD patients covered by Medicare is only 1% of the total Medicare population, spending for ESRD patients totaled $35.9 billion, accounting for 7.2% of the overall Medicare-paid claims. The US also has the highest kidney failure in the world. More and more people also have diabetes. Per Centers for Disease Control and Prevention (CDC) the US currently has over 34.2 million diabetic patients in 2018: 26.8 million diagnosed and over 7.3 million undiagnosed with 1.5 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 out of over 95,000 people waiting for kidney transplants in 2018.
2. Kidney dialysis: they need to come to dialysis centers 3 times a week and use one of the two treatment options:

* Hemodialysis: the blood flows to an artificial kidney machine which uses a special filter to clean out harmful wastes, salt, and excess fluid. 90% of patients use this treatment.
* Peritoneal dialysis: a special solution called dialysate is pumped into the abdomen by a catheter. After a few hours, waste from the blood is carried by dialysate and is drained by the machine. Only 10% of patients choose this treatment option.

Eighty eight percent of dialysis patients prefer to go to the dialysis centers for treatment. The rest chooses home hemodialysis which requires a dialysis machine at home, e.g. machines made by NxStage Medical which is owned by Fresenius. Some of the dialysis centers provide home dialysis training to patients. Per DaVita 2019 annual report, 13% of its patients chose home-based dialysis but 16% of its revenues came from these patients. 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 Medicare. Social Security Amendment of 1972 under the President Nixon extended Medicare coverage to any persons with chronic renal failure. The dialysis service operators in turn have money to punctually pay rent to the landlords. 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 the US in 2020 are:

Dialysis Chain	Patients	Centers	Patients/Center
Fresenius Medicare Care N.A.	211,000	2500	84
Davita, Inc	206,900	2753	75
US Renal Care	25,000	335	75
American Renal Associates	17,300	251	69
Dialysis Clinic, Inc.	15,000	235	64

Fresenius Medical Care is a largest kidney dialysis provider in the world with headquarters in

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Bad Homburg, Germany. It operates 4000 centers worldwide with 2500 centers in North America and has 38% market share in the US. Fresenius with 290,000 employees is the key and dominant player in North America, Latin America, Europe, Middle-East, Africa, and Asia-Pacific with worldwide revenue of $41.9B and $2.229B in Operating Income in 2019.

DaVita, Inc. is the second largest kidney dialysis provider with headquarters in Denver, CO. It operates 2753 dialysis centers in the US with 37% market share in the US and 206,900 patients. It also has 259 dialysis centers in 10 other countries. DaVita reported $11,388B of revenue in 2019 and $1.643B in net income from US dialysis. This means DaVita receives an average of over $55,043 in revenue per patient.

In the last 10 years, both Fresenius and DaVita grew mainly through acquisition of smaller chains. In August 2015, DaVita -- whose largest shareholder is Warren Buffett's Berkshire Hathaway -- 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 leases are often under their hundreds of subsidiaries with tenant's address in Waltham, Massachusetts for Fresenius and Denver, CO for DaVita. The pace of acquisition is expected to stop or slow down in the future as both face antitrust concern from the Federal Trade Commission. Lately, most of the new dialysis centers are built by DaVita and Fresenius.

Typical Dialysis Center

A typical center is a free-standing single-story medical office building 7000-14000 SF in size with a canopy at the front entrance. It has 16-36 dialysis stations, opens 9-12 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.

Dialysis Centers Rating

As an investor, you may think you should invest in a dialysis center with high ratings and avoid ones with low ratings. Currently, Medicare collects various statistical data from dialysis centers about patient death rate, rate of hospitalization, rate of transfusions, percentage of patients with enough wastes removed from their blood. The dialysis centers are then given a rating from 1-5 stars based on the collected data. You can get the ratings of a dialysis center on www.medicare.gov/dialysisfacilitycompare. The main drawbacks of the ratings are:

1. There is no input from the patients as seen on Yelp.
2. If a center has high death rate or high hospitalization, then the dialysis center is the cause of it which may or may not be true.

This author believes the rating is far from perfect. You should not make it the main factor in your decision to invest or not to invest on a center.

Which Dialysis Center Is Best For Investors?

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% rent bump every 5 years. The tenant also has several 5-year options. So, compared to ground leases for brand-name fast food restaurants, dialysis centers offer better cap for investors. When the lease has 1-2 years left, the cap often increases to 7% to 8% 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 new dialysis machines, backup power supply 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. It may take up to 2 years if the new center has to be built from the ground up. On top of that, there is also an issue about what to do with the equipment in the old facility. 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: 1 for being too dilapidated, i.e. unsafe, and 1 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 26 more patients than the average of 84. With each patient generating over $51,500 in revenue, this center has annual revenue of over $5.665M/year. It's a good sign if the rent to revenue ratio is below 5%.
- 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 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 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 compare 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. 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%, Black 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. In higher income area, there are more patients with insurance which reimburse substantially higher than Medicare. So reviewing demographics data to have an idea about the potential number of patients and revenue. In addition, 36 states require a Certificate of Need (CON) before medical facilities are allowed to open or expand. Some CON states, e.g. Michigan do not govern dialysis centers so make sure you do your homework. So it's a big plus if the dialysis center is located in a CON state as it has little or no competition.

Will the tenant vacate when the lease expires?

It's very difficult and expensive for dialysis centers to relocate. It may take up to two years to do so. The process involves:

1. Looking for a suitable location near the existing location.
2. Working with a developer to construct a new center.
3. Negotiating a new 10-20 year lease.
4. Building out and equipping the new center with new dialysis machines, water filtration system, and back-up power supply. The cost could be several million dollars.

Once the new center is up and running, then the tenant can move to the new location. One question is what are they going to do with the equipment in the old center. As a result, dialysis tenants rarely move. And so, as a landlord you have a leverage on your lease renewal negotiation.

Investment Risks

There are risks in any investments and dialysis center is not an exception.

1. Rent reduction during lease renewal. While insurance patients generate more revenue per patients, federal law only requires insurance companies to provide dialysis coverage for 30 months . After that, Medicare will take over. In 2019 DaVita reported an average revenue of $51,500 per patient, down from about $62,387 in 2015. This author believes this is due to Medicare reduces its reimbursement. This creates pressure for tenants to cut down operating expenses. As a result, the author has seen DaVita & Fresenius asking for rent concession during extension even when the rental rate was pre-set in the lease. To minimize this possibility, make sure the rent they pay is at or below market in the area in a center you plan to invest in. Your broker should be able to help you with this.
2. More patients choose home dialysis. Patients using home dialysis tend to have better health since they do dialysis more often, 3-6 times a week versus 3 times a week for in-center patients. However, home dialysis requires 2-8 weeks training and a partner at home with the patient. Currently, just 12% of the patients choose home dialysis. Should the number of patients choosing home dialysis increase substantially in the future, it may reduce the need for more dialysis centers and/or reduce the number of in-center patients and the revenue for in-center dialysis. This in turn creates pressure to reduce rent.