Constantino, Mike

From: Kara Friedman [KFriedman@Polsinelli.com]
Sent: Wednesday, July 13, 2011 4:00 PM
To: Constantino, Mike
Cc: Anne Cooper; 'Chet Mehta'
Subject: DaVita CON Applications
Attachments: Illinois Letter.pdf

Mike,

Please see attached. Project Numbers are referenced in the letter.

Thank you,
Kara

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Via Electronic Mail

July 13, 2011

Mr. Mike Constantino
Illinois Health Facilities and Services Review Board
525 W. Jefferson, 2nd Floor
Springfield, IL 62761

Re: Response to Additional Information Request for DSI Renal, Inc. Acquisition (HFSRB Project Nos. 11-027 through 11-036)

Dear Mr. Constantino:

This letter is a follow up to my letter dated May 27, 2011. You had asked for more specificity regarding the value that DaVita, Inc. ("DaVita") attributed to the 10 Illinois dialysis centers DaVita is about to acquire pursuant to its planned merger transaction with DSI Renal, Inc. ("DSI" or the "Seller"). This letter provides the additional detail you requested.

Overall Purchase Price Determination

With regard to the determination and negotiation of the aggregate purchase price for DSI which is approximately $690 million, this price was arrived at through a negotiated transaction with the Seller. In assessing an offer price to initiate the negotiations, DaVita used several methodologies including (i) a discounted cash flow analysis, (ii) a comparable companies multiples analysis, and (iii) a comparable transactions multiples analysis.

First, a discounted cash flow analysis projects future cash flows of a business, and discounts these cash flows at a discount rate which reflects the riskiness associated with achieving these cash flows. Because the projections were for a limited period of time, all future cash flows beyond the projection period are assumed to be worth a certain multiple of the terminal year's cash flow, reflecting the discount rate and a perpetual growth assumption.

Second, a comparable company analysis analyzes the multiple at which the stock price of comparable public companies trade. Often people are accustomed to using P/E or price to earnings ratios. But typically for assessing an acquisition price, we use Enterprise Value to EBITDA multiples. Enterprise Value represents the total value of the operations of a company and is implied to be the sum of the market capitalization and debt outstanding. That is, it represents the value of a company's operations on a debt free/cash free basis. Since this is a value which is neutral to capital structure or accounting differences between companies, the appropriate ratio is a ratio of Enterprise Value to EBITDA, which is earnings before interest, taxes, depreciation and amortization. Just as with the discounted cash flow methodology, calculating a range of enterprise value to EBITDA multiples of comparable publicly traded companies and then applying that range of multiples to DSI's aggregate EBITDA results in a range of values.

Finally, we examined Enterprise Value to EBITDA multiples of other acquisitions in the same industry. In this case Enterprise Value represented purchase price of equity in the acquisition (as opposed to market capitalization) plus the debt.

None of these individual analyses specifically arrived at a price of $690 million. Rather, they resulted in a range of values, and $690 million was within that range.
After developing a range of values, then based on qualitative factors such as DaVita's estimate of synergies we could achieve in the merger, shareholder perception of the transaction, strategic value of entering markets in which we did not have a presence but in which DSI did have a presence, we further narrowed the range and identified a point value that we offered to the Seller.

At this point negotiations began and the Seller countered with a higher price. There was a series of communications between DaVita and the Seller, during which DaVita was informed by not only the range of values implied by the analyses described above and the qualitative factors identified above, but also by additional information learned in due diligence.

Finally, DaVita and DSI agreed to a price - approximately $690 million for the entire enterprise. Although the arrived at purchase price is not simply represented by applying a single multiple to EBITDA, we often calculate what multiple of EBITDA the price implies. In this case, the purchase price represents a 9 times multiple of forward EBITDA (that is, EBITDA for the first projected year post-acquisition).

Allocation of Purchase Price to Illinois Facilities

With specific reference to the allocation of value to each of the individual Illinois DSI facilities, it is important to note that DaVita did not arrive at the $690 million purchase price through a "sum of the parts" analysis, totaling the value of each individual center. Prior to assessing each Illinois center for the purposes of the Illinois Certificate of Need requirements, we never assigned a value to each individual center. Similarly, there is no accounting requirement that we allocate purchase price to individual centers, as there is a requirement to allocate purchase price to identifiable intangibles, goodwill and fixed assets. As a result, the only purpose for which we had to allocate value to individual centers is in connection with the Certificate of Need applications.

In order to allocate the aggregate purchase price of $690 million to the individual centers for purposes of the Certificate of Need application, we took the ratio of forward EBITDA for a given center to aggregate forward EBITDA for DSI, and multiplied the aggregate purchase price of $690 million by that ratio to arrive at the implied value of that center. For example, if a given center had forward EBITDA of $1 million, and DSI had aggregate forward EBITDA of $77 million, then that particular center represents 1.3% of the total value of DSI, or approximately $9 million. As a technical detail, one facility in Illinois, the DSI Markham facility, is negative EBITDA. Rather than allocating a value of $0 to the DSI Markham facility, we attributed $100,000 value to it to acknowledge that it is a going concern.

Thank you for your time and attention to this matter. We appreciate all of staff's efforts to keep these applications on track for prompt consideration by the Illinois Health Facilities and Services Review Board.

Very truly yours,

Chetan Mehta
Corporate Vice-President of Finance