CHADD GARCIA ON BUSINESS BREAKDOWNS PODCAST
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Introduction: Business Breakdown is a series of conversations with investors and operators diving deep into a single business. For each business, we explore its history, its business model, its competitive advantages, and what makes it tick. We believe every business has lessons and secrets that investors and operators can learn from, and we are here to bring them to you. To find more episodes of breakdowns, check out joincolossus.com. All opinions expressed by hosts and podcast guests are solely their own opinions. Hosts, podcast guests, their employers or affiliates may maintain positions in the securities discussed in this podcast. This podcast is for informational purposes only and should not be relied upon as a basis for investment decisions.

Zack Fuss: I'm Zack Fuss and today we are breaking down Chemed. Chemed represents the union of two seemingly distinct businesses, end of life healthcare and plumbing services. As our guest, Chadd so aptly puts it., old houses and old people. The two underlying businesses, Vitas and the widely recognized Roto-Rooter, both offer interesting stories in their own right. The strength of this business has been its intentional and well-executed capital allocation strategy, which has resulted in a 21% EPs CAGR since 2003, which has resulted in a market cap of $8.5 billion and a net cash balance sheet. As mentioned, Chemed operates through two very distinct, wholly owned subsidiaries that seem pretty far apart. On the one hand, you have Vitas Healthcare, a leading provider of end-of-life hospice care in the US, founded in 1978. And in the other, there's Roto-Rooter, the iconic plumbing, drain cleaning and water cleanup service provider whose roots go all the way back to 1935. So, I'm sure you're thinking, how did an end-of-life healthcare company and an emergency plumbing business end up under the same corporate umbrella? Through this conversation, we'll trace Chemed's history from its origins as a spin-off of W.R. Grace to the strategic decisions that led to acquiring Roto-Rooter in 1980 and Vitas Healthcare via its recapitalization in 2004. We'll delve into the nuances of each business the highly regulated, deeply personal nature of hospice care provided by Vitas and the demand driven, widely recognized services of Roto-Rooter, a major player across the US. We'll discuss their unique business models, the growth drivers of the businesses, and why Chemed and its management team believes that this unique combination ultimately works for maximizing shareholder value. To break down Chemed, I'm joined today by Chadd Garcia, a portfolio manager of the Ave Maria Growth Focused Fund. We hope you enjoy this conversation on Chemed Corp.

Zack Fuss: All right, Chadd. Great to have you back. Today we are breaking down Chemed, which brings us the exciting topics of hospice care and plumbing services. And so, to kick things off, let's just talk about how a business like this came to be. Your experience learning and studying the business itself, and how we ended up with two somewhat characteristically similar businesses, but in wildly different end markets.

Chadd Garcia: Good to be with you. So yes, Chemed, old people, old houses. As my friend once told me when he started looking at it, I call it the haiku of the Midwest, though if you know haiku, when you listen to Lawrence Mendelson, the CEO, he says, you know, we're not in the aerospace business, we're not in the defense business. We're in the business of growing free cash flow per share. And the first time I talked to the management team in 2020, they said, "Our business is to grow our free cash flow per share, and we're agnostic on how we do it. We have two businesses right now, and if somebody gave us a great price for either of them, we may exit it. And if a great business comes along, we may get into that too. We grow our free cash flow per share. The more I dug into that, the more evidence I saw that they lived by that value. And I wondered why they weren't in the first edition of The Outsiders. Because, you know, it's definitely a business that has done well managing their operations and has had fantastic capital allocation. The only reason it probably wasn't in it is because nobody knows about it. I mean, there were maybe one to three analysts at any given time that covered the company. Maybe two analysts that covered it in 2020. They reported their first quarter earnings. And there was one analyst on the call today. Not too many people know about it.

Chadd Garcia: Let's get into the history of it. The business was formed in the early 1970s when it was spun out from W.R. Grace, which was a chemical company. Grace spun out a specialty chemicals business. So that's the chem part of Chemed. And they spun out Omnicare, which is a pharmacy services business. That business maybe a decade ago was bought by CVS. So that's the med part of Chemed. In the 1980s, they had a couple large corporate transactions. The first one was they bought Roto-Rooter, the plumbing services business, and then a year later they spun out Omnicare. And so that left Roto-Rooter and their namesake specialty chemicals business. Fast forward a couple of years to the 1990s. They had a couple more large transactions. The first one was that a company approached them to acquire their chemicals business. I think they were very happy with their business, and they're happy to own it and grow it. But the price was too good for them to pass up. And so, they sold their namesake specialty chemicals business that gave them a pile of cash. They ended up financing a private equity players purchase of Vitas. They put some convertible debt into Vitas to finance the transaction. That gave them a 20% stake in the business. Over time, that position grew to 37% in the business. Fast forward to 2003. The sponsor came to them and said, "Get ready, we're not ready to sell the business. And Chemed's management asked the sponsor what their price expectations were, and they gave him a price.

Chadd Garcia: And they're like, well, we're not sellers for that price. We're buyers. And so, they ended up buying the remaining stake of Vitas. And since 2004, they've held Roto-Rooter and Vitas, and they've grown them both. Both of them grew organically. And then with respect to Roto-Rooter, they put some money into acquisitions to acquire some of the franchises. That business has some franchises outstanding. So, they've been acquiring their franchises. Vita's they mostly grew via Greenfield, with the exception of last year. They were able to make an $85 million acquisition, but for the most part, they didn't make any acquisitions. The business generates ample free cash flow, both as businesses have high returns on capital. Corporate pays a very small but de minimis dividend, and they do it for a couple of reasons. Some investors require dividends in order to own a company. Other investors require that that dividend be grown in order to start a position in the company. And so, they pay a de minimis but growing dividend in order to check those two boxes. And so, if you look at the amount of free cash flow the company generated since 2004, they generated around $3.7 billion. That's a net of six, seven, $800 million worth of capital expenditure throughout that time. They've spent about $700 million on acquisitions. They paid $300 million on dividends, and they've bought back $2.5 billion worth of stock. So, they've taken their share count down from twenty-five million in 2004 to 15 million today.

Zack Fuss: A share cannibal with adept capital allocation, as you alluded to. I want to dig into the actual businesses. So today, the enterprise itself sports a valuation of around $8 billion, revenue approaching $2.5 billion and $500 to $600 of EBITDA. Can you just break that down between the two businesses? And then we can dig into the qualitative and quantitative characteristics of both of those businesses and what exactly they do.

Chadd Garcia: Roto-Rooter is now the smaller of the two businesses, probably 30, 35% of the earnings. It was founded by a man named Sam Blank in the 1930s. Sam invented a drain cleaning piece of equipment by taking a Maytag washing machine motor and attaching a cable to it with some blades, and that allowed for the cleaning of drains prior to that. If a drain was severely plugged, it required to be excavated, and oftentimes the pipes replaced, and so that was a new technology in order to grow the technology. Sam set up a lot of franchises which gave people exclusive rights to operate within a given area. Fast forward today, the company has three business lines. One would be company owned branches. You'll find these in very large metropolitan areas. That's where Roto-Rooter, the company, has the right to operate in a large metro area. They'll own the business that does all the plumbing services within that area. There are franchisees, as we discussed in this business, the franchisee owns the rights to the Roto-Rooter name within a certain geographic area. They pay Roto-Rooter a small fee, but they receive almost no support from corporate. Roto-Rooter figured out that they can run these plumbing businesses a lot better than a lot of the franchisees, because they have the benefits of scale with respect to the back office.

Chadd Garcia: They are also better at marketing and doing search engine optimization and other marketing functions. And so, they want to acquire as much of these as possible. If they acquire a franchise that serves a large metro area, they're likely to turn that into a branch and operate the business themselves. If they think that the business area that serves is a little too small. So, think about a mid-market area or a rural area. They will partner with an independent contractor to operate the business and provide plumbing services with respect to their independent contractors. Roto-Rooter is very hands-on with respect to providing back-office support and providing a lot of marketing support, but their partner provides the actual plumbing services. This is closer to a franchise model that we would see, like in a restaurant or other businesses, for the benefit of being an independent contractor to Roto-Rooter, you get the benefit of all the back-office help and the marketing help, and then you pay them a 28% royalty fee.

Zack Fuss: We'll come back to kind of the ebbs and flows of Roto-Rooter businesses and its different services. But how about a similar overview of the business and how it came to be?

Chadd Garcia: One quick note if you look at Roto-Rooter history, they have grown their revenue about 6% clip. That's about standard for them in a 2 to 3% normal inflation environment. And then because they've been expanding their margins, they have about 25% EBITDA margins. But because their margins have been expanding, their earnings growth has grown by about 12%. We'll get into that business, but it has about the same profile with respect to low mid-single digit revenue growth, low double-digit earnings growth. And then when you combine it at a corporate level and you layer in all the share repurchases, they have, their EPs grow at about 2,021%., and their stock price over the last 21 years has compounded at about the same rate. Vitas is a hospice and palliative care provider. What hospice care does is it provides health care to patients who are in their final days of their life. When you're in your final days, you have a couple courses of action with respect to healthcare. You can continue to try to receive curative care, which is quite expensive and oftentimes ineffective, may actually do more harm than good. Or you can opt for palliative care, which aims to manage your pain and make it more comfortable in your final days. Vitas provides that, and it's provided 99% of all the care is provided in a patient's home. If you're in your final days, one can imagine that it would be more comfortable for you to be in your own house, as opposed to a hospital. Hospice providers enable that to happen.

Zack Fuss: Now that we have a good summary of the two businesses, I'd love to do a deep dive into Roto-Rooter itself. Why is this a good business? Why is it defensible? What enables them to earn returns on capital? They do, which, according to your math, are incredibly impressive. Just kind of explain the nature of these plumbing services businesses and why the Roto-Rooter brand bestows such an advantage onto their franchisees, independent contractors, and company owned branches.

Chadd Garcia: Well, I think Roto-Rooter is the gold standard for emergency plumbing service. If your drain is clogged, Roto-Rooter can be top of mind. About 70 to 75% of their service calls typically are emergency care or same day service. If you're at home and your sink's clogged and your family has dinner to make, you don't want to wait around for several days to fix a problem, you call Roto-Rooter, and they can be out the same day and they fix it. And people are generally price insensitive to that. Rooters' revenue is driven by population and new business and new household formation, so that's going to drive the top line. Other than that, it's about how quickly you can get out to somebody's house or business and provide the service that they need. If you look at how that has worked out for them, they've provided pretty good quarterly data on each of these businesses going back to 2012. And Roto-Rooter has had up until recently, maybe three quarters between 2012 and 2023, where they had negative growth. The cyclical nature is pretty evident. Recently they have had some problems, and the problems are a few-fold. They started in the first quarter of 2023 with some negative comps, and those problems have persisted a bit. But when Covid hit, as you can imagine, their commercial revenue was impaired because restaurants and businesses closed down, hospitals locked people out.

Chadd Garcia: But given work from home, there was a massive pull forward in demand and a massive new demand because people were using their homes more. And if you use it more, things break and drains get clogged. Roto-Rooter was a huge Covid beneficiary. I think that there was a fair amount of demand pull forward, as people may have replaced faucets or other plumbing fixtures that they have tolerated for years, but when you're around it every day, you want to get it fixed. The inflation that happened post Covid may have given some people some incentive, instead of hiring Roto-Rooter to replace a garbage disposal, maybe learned how to do it themselves. So, there may be some of that going on as well. In recent years, private equity has emerged as a formidable competitor. That started to be felt in 2021, although Roto-Rooter did quite well, benefiting from the initial post Covid work from home boost. But they started to see private equity, starting to hire some of their general managers away in 2021. And then recently, we've seen the competitors get pretty savvy with respect to some of their search engine optimizations and marketing.

Zack Fuss: Broadly, if I consider local plumbing and services businesses, what are the barriers to entry and why are there structural advantages for Roto-Rooter versus the private equity upstarts?

Chadd Garcia: As I said, the emergency care is 70 to 75% of their services. That is ticking up a bit. The CFO didn't disclose what it was, but he says it's higher. That shows me that Roto-Rooter has some brand relevance with respect to emergency services. Both the private equity players and Roto-Rooter should benefit against mom and pops. Roto-Rooter in plumbing overall probably has a 2 to 3% market share. In drain cleaning, they probably have a 15% market share. The larger players can be savvy with respect to search engine optimization and marketing and beat out a lot of the smaller local businesses. With respect to how Roto-Rooter is going to compete against the private equity players. I think Rooter has been at it for a lot longer. They've learned from their mistakes. There are two private equity players that they've been running into a lot. One is called Apex, which is owned by Alpine investors. One is called Ben Franklin, which is owned by Apex. Some of these players are combining the roll up of plumbing businesses with other home service businesses such as HVAC, Roto-Rooter tried rolling out HVAC in the nineties. It didn't really work out well for them. They're not really too bullish on this working out for private equity players. In 2021, the private equity players picked off about 20% of the general managers of Roto-Rooter. They did go after Roto-Rooter employees, and hire away the general managers, who also took down the next level of management beneath them, because those are general managers, took people with them to the new firms. Within a year and a half, two years, half of the general managers had returned to Roto-Rooter. I think that there will be a benefit to Roto-Rooter as being an owner in his business, as opposed to a renter. I think the general managers that left and came back may have learned that the grass isn't greener on the other side all the time.

Zack Fuss: In regard to capital allocation, I know they've been trying to buy back franchisees, or I believe in their corporate presentation. They talk about targeting 6 to 8 times EBITDA for a business that I believe trades at 15 times. So, from a value creation perspective, very accretive. How significant of an opportunity is there to buy incremental franchises at this point?

Chadd Garcia: If you look at the history of them buying back franchises, most years, they're spending less than $10 million. It historically has been small. There have been a couple of years. So, if you look at 2018 and 2019, they did a couple large transactions where cumulatively they spent just under $200 million on M&A at Roto-Rooter. I don't think that there are too many of those opportunities out there where you can do a large deal in one fell swoop. There's 360ish franchises around. I think they'd probably want to buy them all, but it's going to be a franchise here, franchise there probably less than $10 million a year in M&A at Roto-Rooter. I think that the opportunities to do big deals are probably gone. When I talk to the CFO about it, the price isn't really as much as an issue. The determining factor is just when the franchise owner wants to retire and exit the business.

Zack Fuss: And then in terms of business mix, I know emergency plumbing services are kind of their bread and butter, but their excavation business seems to be growing and significant. How have they been able to cross the chasm from that consumer to B2B side of the business? And what does the opportunity look like in furthering that?

Chadd Garcia: Well, they have a commercial business. So, you have residential drain cleaning business, which is probably about 17% of sales. You have another 13% for residential plumbing. So just replacing faucets, replacing garbage disposals. But they've been in the commercial business for some time because they also need plumbing services and drain cleaning services. Excavations are a bit different. So that's where you're partnering with contractors on very large jobs. That's a little newer. I think it's something that they are focused on quite a bit. They talked about it on the call today. It's a more competitive business. They want to be part of it. And so, they've talked about the margins coming down a little bit because they're pricing to be a little bit more competitive in that business. But it drives large volumes.

Zack Fuss: And what's the margin profile of Roto-Rooter overall and how has that trended?

Chadd Garcia: It's about 25% EBITDA margins any given year. And it kind of goes up and down in any one quarter or any two quarters, but about 25% EBITDA margins. The one interesting thing from the call today was that their branches are performing remarkably well. And that makes sense, because the Corporate's got a lot more control over the branches than they do with the franchises and independent contractors. Revenue grew overall but leads coming in were down seven 8%. And so, what that tells me is that they're probably being less aggressive on search engine optimization and competing in that manner, which may have lowered their leads, but the leads that they get, they are converting those to sales at a higher rate.

Zack Fuss: So, they're seeing higher quality leads, I guess, just to make sure that we have a good understanding. It looks like around two thirds of their EBITDA is from their branches, whereas the remaining third are split between contractors and franchisee fees, with the franchisee fees being smaller proportion of that. Can you just walk us through the basics of the three models and how they're different?

Chadd Garcia: With respect to the branches? You own the whole business. So, it's a normal corporate income statement with respect to the franchise fees. They have 360 franchises. So, if you look at maybe they have $7 million in franchise fees a year. If you divide that out, that's probably $15,000 per franchise. They'll tell you that what the franchises pay is determined on the population base that they serve, but they're not getting much money from the franchises, and they don't spend any money on them. So that should be the highest margin business. If it's close to 100% margin, but it's small 6% of their overall earnings. And then 21% of their EBITDA comes from their contractors. And so that's the 28% royalty that they get from their contractors. But they supply a lot of the marketing services in the back-office functions. So that's going to be a higher margin than their branches but less than the franchises.

Zack Fuss: And then how has it been evolving over time in terms of mix?

Chadd Garcia: They've been slowly acquiring franchises and converting them either into independent contractors or branches.

Zack Fuss: And then, you know, you haven't made a lot of mentions to management, although typically in stories where capital allocation is a primary driver of value creation, management is important. I know the CEO of the business is a lifer. What's your experience with the management of this company and what does succession look like there?

Chadd Garcia: Well, most of my experience has been with the CFO, primarily the former CFO, over the course of several years since I invested in this in 2000. I've recently started to spend a lot of time with the current CFO, but they are hard to get in front of. They are covered by one, two, or three sell side firms at any given time. These sell side firms tend to be on the smaller side, so it's hard to get to some of the conferences that these guys go to and get in front of them. Back to the CEO, Kevin McNamara. He started out at the pharmaceutical services business, Omnicare. He became general counsel of CMD in the eighties. He became CMD's president in the nineties. In early 2000, he became the CEO. He's 70 years old. He doesn't seem to be stopping yet, but given his age, it's good to be looking at who's next in line. Nicholas Westfall is the current CEO of Vitas. He's been with the company, I believe since he graduated from business school in ‘09. He's been a long-time participant of the quarterly calls. He'd be my guess that he's probably next in line for the CEO job, given his age and Vitas relative size to their overall business. Regarding the company's culture, I see it in their actions. Like how do they allocate capital? Are they consistent with what they said they would do? Are they consistent with what they've communicated to me that they exist to grow their free cash flow per share in the business units? Like how do they treat their patients? Do they go above the Medicare cap for high acuity patients from time to time? From time to time, they do.

Chadd Garcia: It costs the company money, but it's the right thing to do for the patients. I mean, go back to the fine that they paid for the False Claims Act charges. It seemed to me that in that situation, they were treating high need patients when the reimbursement rates were too low. And a lot of the other industry players weren't doing that. In my mind, which shows the integrity that the team has and management's culture. Do they treat their employees well? During the post Covid healthcare worker crunch and high inflation, they implemented a substantial retention program in their business, and they were able to recruit employees from other firms. Are they good spokespeople for the industry at that same time? Their margins were lower than usual, but their margins were still satisfactory. The bottom 50% of the industry whose margins are materially lower. These firms were in jeopardy of going out of business. Vitas was reaching out to the government to advocate that they upped the reimbursement rates sooner than the government normally would. That was done to save the industry, not protect their margins, which were lower for a period of time, but still fine.

Zack Fuss: I think that's a robust summary on the Roto-Rooter business. It is tough to find an easy segue over to hospice care. From a business characteristic perspective, maybe just start on the similarities you see between the businesses, and then we'll follow up with what exactly the hospice business does and how it's grown, and the strengths and weaknesses and challenges facing that business.

Chadd Garcia: Well, to start, both of the businesses are highly fragmented industries. And so, if you look at Roto-Rooter, there are probably 2 to 3% of the overall plumbing market, 15% of the drain cleaning market. If you look at Vitas, Vitas is probably 12% of the hospice market. Neither of them requires many assets, but they are people intensive. They don't require much capital to grow, but they generate high returns on capital and spit off a lot of free cash flow. And then both of them are fairly cyclical.

Zack Fuss: The hospice business itself was interestingly acquired a few decades ago through prior financing. How has that business evolved? What does it do? Why do you like the hospice business?

Chadd Garcia: The business has compounded its revenue at 6%. They really didn't utilize acquisitions as a way to grow it. So that's all for the most part, organic in green fielding. The earnings have grown at a faster rate as they expanded their margins. The EBITDA margins for this business range between 15 and 22%. They were able to make a large acquisition recently. When I look at this business, aside from the high returns on capital that it generates and the massive free cash flow. I look at the tailwinds that this thing has coming up, and I think it's massive right before Covid. There are 2.5 million Americans who pass away every year. Presently, we have about three million that pass away. Fast forward to in the 2040s, that number should rise to just under 4.5 million people every year in plateau for a long time. There's definitely going to be a rising demand for palliative care services. And then if you look at one of the other major players in the business, it's the government. The government pays 96% of the bills for palliative care services, and 93% of that is Medicare. What service does the industry and Vitas provide to the government? Thirty percent of Medicare's expenses come in the form of paying for health care in the last year of a person's life, and most of that is within the last six weeks. And it usually comes within two forms first, paying for curative care that's not effective and could do more harm than good, or dealing with episodic events via emergency room visits, ambulance transportation, and hospital visits. There are episodic events that can happen in the final days of a person's life that are quite scary for their caregivers, which mainly are their family members. That often leads to expensive hospital visits. The hospice industry and Vitas train these caregivers on how to deal with episodic events, so their patients don't end up in hospitals to be stabilized and then shortly after, return back to their house. This industry saves Medicare an ample amount of money. And so that's something that the government should want to support and continue.

Zack Fuss: More specifically, the size and scale of the Vitas' business growth trajectory, how they've been able to kind of grow their business organically, and what the characteristics of it are from a margin perspective. Just kind of take us through the business.

Chadd Garcia: They're doing about a billion in revenue every year at 16 to 20% EBITDA margins. Historically, the growth has been 6% revenue growth, 12% earnings growth. But with the tailwinds that I just mentioned, I think that that growth rate is going to increase for a good amount of time.

Zack Fuss: How does the business make money exactly?

Chadd Garcia: The business makes money by getting paid to provide care. And that payment comes in a few different ways, but it's easiest to think about it in an average reimbursement rate per day of care. There are some add-ons to that. If high acuity care is needed, let's say somebody does have an episodic event and that requires a full-time nurse or let's say that family member who's providing a lot of the day-to-day care and needs a break, then they'll provide respite service for serious patients. They'll provide inpatient care, and so those are reimbursed at a higher rate. The biggest cost for the program would be the nurses that do the day-to-day checkups, and the setting up a client and training the family caregivers. And then you have some medical equipment and pharmaceutical products that the patients need as well.

Zack Fuss: And then in terms of controlling margins, clearly, you're dealing with CMS and not the government as a payer. Can you kind of take us through that dynamic and how their revenue is influenced by the government and the dynamics that they're managing?

Chadd Garcia: Let's start with the margins part of it. And I think the margin part; they're a bit clever with where they choose to compete. And so, before you get to the federal regulations, you have state regulations on whom a state would allow in the business. And so, some states are more stringent on who gets into the business, and some are less. If you look at California, they're less stringent. Los Angeles County by itself has probably 1900 different hospice operators, whereas in the state of Florida, there's probably fifty state regulations that can limit the competition. While Vitas does operate in California, for the most part, they operate in states that have more stringent regulations. The other thing that they do is they pick what cities they want to operate in, so they only operate in higher population areas, and that allows them to better manage the utilization of their assets, which is namely their people, because they can better manage the utilization levels of their people by serving a larger population base. They have 15 to 22% margins, whereas the bottom 50% of the industry has 6 to 9% margins.

Zack Fuss: From a competitive landscape, are there any other scale players that are worth evaluating as perceived competition, or is it local players that have subscale?

Chadd Garcia: It is highly fragmented. Now there are large players that are independent. Graham Holdings is one. That business also does some home health care business. So, it's not a pure hospice provider. Hospital systems can have associated hospice providers. Assisted nursing facilities can have associated hospice care palliative service providers. You can kind of think that the industry is made up of independent mom and pop, quote unquote, nonprofits and hospice care providers that are associated with other health care providers, such as hospitals and assisted living facilities. There is a benefit of scale and so hence Vitas' preference for being in more population dense areas. And so, they can get the benefits of scale.

Zack Fuss: And then management is adept at navigating these Medicare caps, which limit the amount of time a person can spend in hospice. Because from the government's perspective, they want to provide quality care for the end of life, but they don't want it to drag on for months at a time. How is that something that they are able to address? And can you kind of explain that dynamic as it relates to Medicare payments?

Chadd Garcia: This is the government in healthcare managing reimbursements. And so, the regulations are highly complicated. But there are a couple of things to think about. First, the government limits high acuity care payments to 20% of the overall bill. No more than 20% of that bill can be spent on high acuity care. They also limit the total amount of money that's spent on a patient. And so right now, the maximum that can be spent is $34,560. So, it is just under $35,000. If you assume that the average revenue per day for normal care is $200, it's just over that. But say $200, that gives you around 170, 175 days of care before the government stops paying for it. With respect to people coming into the program, there are three signatures that are required that sets up a check and balance in order to be eligible for hospice care. The patient's attending physician needs to attest that the person is terminal, and that the end of life is expected to be imminent, and so they have to sign a form attesting to that the hospice provider. So, in this case, Vitas, their physician, has to concur and sign a form. And then finally, the patient or their proxy needs to sign a form and agree to enter the program. That's kind of the check and balance with respect to who gets into it. Ultimately, the government stops spending after the cap is hit, and then on the other side of it, they limit on how much they're going to spend for high acuity care. And both of these limitations are done on a portfolio basis, not on an individual basis.

Chadd Garcia: So, if you're a hospital and you have an associated hospice, for the most part, people that come from a hospital are further along in their disease process. And so, their stay in a hospice program is rather short. It could be so short that they're unprofitable because there is some upfront expense. When you take somebody into the program, you have to fill out all the paperwork. You have to order medical supplies; you have to order pharmaceuticals for the patients. And so, if you do that on day one and they die on day two, then you can be at a loss. Also, these patients need high acuity services if they come from a hospital. And so, the hospitals run the risk of breaching 20% of the bill being spent on high acuity care. And if you look at the other end of the spectrum, let's say you have an assisted living facility. People that come into a hospice program from assisted living facility tend to live longer than those who come in from hospitals. Those organizations run the risk of exhausting the $34,560 cap, because a person may live for too long. Vitas has a variety of different sources where patients come from. From a portfolio basis that allows them to manage both of those limitations. To some extent, it could be a pressure valve release for hospitals or for assisted living facilities, let's say assisted living facility population. They're at their max. They can start sending patients to Vitas in order to help manage their portfolio.

Zack Fuss: And so how do you win market share? Presumably, they don't have a monopoly in the regions with which they operate. There are patients that are coming into hospice programs on a daily basis. Can you kind of explain how that works?

Chadd Garcia: You have sales representatives that go into hospitals, which talk to patients, who talk to families. You have sales representatives that go into assisted living facilities, which talk to patients and talk to families. This business was very similar to Roto-Rooter. When going from 2012 to Covid, there were hardly any quarters where they had negative growth, and the ones that they did have were more of a payment timing issue related to the 2013 budget sequestration. But when Covid hit, hospitals shut down, letting outside people in, and so did assisted living facilities. And so, their ability to market at that point was impaired. Hence the negative comps they experienced in the early days of Covid. It's kind of blocking and tackling boots on the ground sales force.

Zack Fuss: Much like Roto-Rooter. Is it fair to say that this is mostly just a business that kind of allocates labor? Presumably, they don't have centers that they operate. There are staff members that they send to provide care.

Chadd Garcia: They do have inpatient care, but that's like 1% of the service. Ninety-nine percent would be in a person's home. But if a patient's needs can't be managed at home, they do have inpatient care. So, you do have those assets. To your point, it is much less than like managing the labor component of it. One way to get market share is to take advantage of industry disruption. The government sets the reimbursement rate, and they do it once a year. And it's based to some extent on inflation. When Covid hit, there was massive inflation within the healthcare sector, and it was difficult to get nurses. And so, you saw them invest in Vitas. They put $37 million into retention bonuses for their nurses. And then they spent another $3 million recruiting new nurses to come into their program, which set them up really well to take market share once the hospitals and assisted living facilities reopened. And if you look at the results of that, they had negative comps from Q4 of 2020 through Q4 of 2022. And then they had two quarters of single digit comps, and it's been double digits low to high teens ever since. Vitas can be in a position to take market share when there's a disruption in an industry such as high inflation and a government that may be a little bit slow to increase the reimbursement rate during extraordinary times.

Zack Fuss: Bringing it all home at the onset of this conversation, we elaborated on the capital allocation prowess of the business in their corporate presentations. They also suggest that there's a willingness to split these two businesses up. Interestingly, the business runs in a net cash position. They're aggressive in their buybacks at times when the stock is dislocated. What is their philosophy around allocating the incremental dollar? Why do they run their balance sheet so conservatively? And at what point would it make sense for these businesses no longer to coexist?

Chadd Garcia: Go back to the philosophy of the management team. Their job is to grow the free cash flow per share. And I think that Roto-Rooter is a great business. It's got a little bit of challenge recently, but I think they're very happy running it, and I think they're going to work through those challenges. And so, the only reason they would sell it is that somebody offered them a price that was too good to pass up. Other than that, then why sell it? With respect to Vitas, I don't think we'll know the answer anytime soon, but it will be interesting to see how this industry continues to consolidate. Is it going to consolidate where independent entities like Vitas become the dominant players? That makes sense because of how the reimbursement structure is. That makes sense to me that you want a portfolio, or does it make sense that you want this business partnered with another healthcare provider, like an assisted living facility or a hospital? If that turns out to be the case, then I could see Chemed acquiring some other healthcare businesses to partner with Vitas so I can see them just selling Vitas. At that point, which would make sense to sell. If the independents aren't going to be the dominant players in the business, another reason for them to split the two businesses would be if this ever trades at a protracted discount, and I don't think that's the case. It could be a little more richly priced than it is today, and the management team is going to deal with that by buying back stock. But if this ever traded at a substantial discount then I would see them sell, spin separate the two businesses.

Zack Fuss: When you reflect upon your study of this business and the story of its composition and evolution, what are the lessons you take away from it and apply to other aspects of your investments?

Chadd Garcia: Well, from an operational standpoint, them choosing editors to be in certain markets that allows them to have margins that are top of the industry, provides that business with an ample amount of protection. One of my core theses is on this business is that it saves the government an ample amount of money, and the government should want to support it over the long term. Over the short run, government can act a bit irrationally, and we've seen that in how slow they were to adjust the reimbursement rates in Covid. But Vita's margin structure, being two, three, four times higher than that of the bottom half of the industry, provided them with an ample margin of safety and the ability to take advantage of those short-term disruptions. From a capital allocation standpoint, it's often very hard to determine if a management team ex-ante is going to be a good capital allocator. But it helps if structurally there's just the business is set up to do it. So, if you look at these two businesses, both of them generate an ample amount of cash and they require very little to go back into it. Yes, there are opportunities to acquire franchises, but for the most part, it's small at Roto-Rooter. Yes. Recently there was an opportunity to make an $85 million acquisition at Vitas, but maybe they get another 1 or 2 of those. I don't think they're going to get too many. They're able to compound their earnings growth at a high rate and have an ample amount of cash. And then how do you manage that cash? You can do a programmatic buyback. You might see Ecolab or AutoZone, or you can just let the business build cash. And when the stock price drops below its intrinsic value, you step in size, which is what this team has tended to do over time, I think because of their philosophy of growing their free cash flow as their reasons for existence and the minimal capital needs of the business. You could have seen a decade ago that these guys were going to be great capital allocators, and I think you can get comfortable that they'll continue to be.

Zack Fuss: As you said, old people and old homes. A unique but enduring business. A capital allocation strategy which has been proven to drive total shareholder return and earnings per share growth of nearly 20% for 20 years. So, nothing to scoff at there.

Chadd Garcia: This is like the get rich slowly strategy.

Zack Fuss: Great. Thanks, Chadd.

Chadd Garcia: Thanks, Zack.

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