CREDO

Frist class

HCA Healthcare is the largest "for-profit" hospital owner in the United States and we have owned the share since 2015. The company operates hospital and outpatient centres offering a full range of services, including general surgery, cardiology, neurosurgery, oncology, orthopaedics, obstetrics, diagnostics, and the like.

After releasing Q1 earnings in April this year, HCA's share price dropped as much as 22%, hence now seems an opportune time to revisit the investment case. HCA's stock had reached an all-time high just prior to that (as compared to a relative weak stock market year-to-date), so it is safe to assume that a downgrade was largely unexpected.

Whereas revenue did meet expectations, profit margins were impacted by inflated labour costs, related to the recruitment of temporary nurses who are paid much more than permanent staff. Publicly listed peers reported similar downgrades over the next few days. The explanations were consistent: hospitals were staffed for peak Covid volumes, however, Omicron cases turned out to be of lower acuity.

We expect margins to recover from here for two reasons. Firstly, labour supply is "sticky" in the short-term but much more flexible over the medium-term. This is not the first time we are faced with this issue. Back in 2015 when we originally invested in HCA, margins were temporarily depressed due to labour shortages associated with "Obamacare" which had materially boosted demand. Secondly, the current margin guidance is equivalent to the levels prior to Covid, which had been very stable over the prior decade.

Looking forward, the tailwinds of Covid becoming endemic, a backlog of elective surgeries, and efforts to recruit more permanent staff are all relevant: in combination, we believe these factors translate into a scenario where margins are likely to have bottomed.

HCA has a colourful history. It was the brainchild of Tommy Frist Jr, the current chairman, whose family still owns approximately 23% of the company. Frist Jr came up with the idea whilst working as a military doctor during the Vietnam war. He was inspired by the success of regional chains such as Kentucky Fried Chicken (KFC) and Holiday Inn which leveraged economies of scale to offer a standardised product, comparable to local competitors, but at lower cost and greater profitability. Superior returns on capital provided the fuel to grow market share by reinvesting retained earnings, attaining yet more scale.

Jack Massey, the legendary businessman who bought KFC in the mid-60's and transformed it into a massive chain, was a friend of Frist Jr's father (Tommy Sr, a well-respected doctor). Massey had unsuccessfully attempted to recruit Frist Jr for KFC, after which Frist Jr pitched him his own idea. The rest is history. In 1968, Massey and the Frist father-son duo launched "Health Corporation of America". Over the past 50 years, HCA has completely transformed the city of Nashville, which is today known as a major healthcare centre (spawned by HCA), in addition to its reputation for "honky tonk" bars.

Prior to HCA, the healthcare industry in the US was almost exclusively comprised of "non-profits" such as foundations and trusts. In theory, non-profits benefit from tax exemption and do not have to generate returns for shareholders, but in reality, they are often blighted by mismanagement, mediocrity and inefficiencies. Profit motive is indeed a powerful incentive. Adam Smith, referred to the "invisible hand", which describes

CREDO

in somewhat paradoxical manner the greater benefits to society overall where individuals pursue their own self-interests.

To this day, the US hospital market remains highly fragmented due to varying state-wide regulations which deter consolidation in certain states. Whereas HCA's approximate 4% national market share might seem low at first glance, in reality the company is a leader in certain states and cities where it has scale, density and bargaining power. According to the company, it has number one or two potions in most of the local markets in which it operates, while its top ten markets generate about two thirds of revenue. In particular, HCA targets southern (mostly Republican) states and urban areas with favourable demographic tailwinds such as ageing and growing populations. By way of example, roughly half of HCA's capacity is in two states, Texas and Florida, which are two of the largest states with fast growing populations.

What made HCA a great investment back in 2015, makes it a similarly great investment today, in our view. The shares trade on a similar P/E rating today as it did back then (about 12 times), which remains an attractive discount to the S&P 500 Index. Absent any P/E re-rating, we would still estimate annual returns in the low teens to be achievable. The company should generate mid-single digit organic revenue growth, with high visibility. Margins seem skewed to the upside. As returns on capital and free cash yield are both attractive, HCA have a lot of optionality in terms of capital allocation. They can bolster growth by expanding capacity, making acquisitions, or return excess capital through share buybacks and dividends. We believe that the stock deserves to trade at a higher rating, given that it should grow faster than the market. Moreover, the founder, Frist, has retained his stake in the business. We look forward to seven more successful years as shareholders! ■

Important notice