Birth of a digital healthcare giant

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Teladoc Health's takeover of Livongo creates a very capable and competent digital health company that could revolutionize the US healthcare system.

Teladoc Health is a small player in the healthcare industry and will still be even after the takeover transaction: With estimated annual revenue of USD 1.8 bn in 2021, the company will not even represent a thousandth of the total US healthcare market of USD 3.5 trn. But that is not what counts. The combined entity has the potential to become the very first platform with the financial wherewithal to grow and evolve into a fully integrated provider of virtual care services. A market capitalization of USD 25 bn and no imperative to generate profits within a mid-term horizon will enable Teladoc Health to invest more than USD 1 bn a year from its own cash flow to grow the company (estimated gross profit for 2021 is currently USD 1.2 bn). On top of that, the company can raise an additional USD 3-4 bn a year from investors and shareholders, should it want to fund even larger growth projects.

"Teladoc Health's management seems to be doing everything right."

Digitization of the healthcare system has only just begun

Some investors are already asking whether this transaction is a sign that the digital health market is overheating. Certainly not! The race has only just begun. One of the key reasons for our confidence in the potential returns that digital health offers is the fact that the whole healthcare system is neither industrialized nor digitalized. Regarding pending and inevitable developments in healthcare industry, there are already countless examples of change in other sectors that have ended in success. The technology risk is also reasonably under control: Recent technology-driven developments in the healthcare sector have already been deployed and applied in other industries for more than 10 years.

Is this the "Big Bang" for virtual care?

The notion that Teladoc Health's takeover of Livongo marks the birth of a new "Amazon of the healthcare industry" cannot be completely ruled out. Up to now, Teladoc Health's goal was to become the number one access portal for people with acute medical problems. Most Americans do not have a primary care physician. The simple solution for people with symptoms or medical questions is to call Teladoc Health or use an app that allows them to send a text or video message to a doctor. If their question cannot be resolved virtually, they will be referred to a specialist doctor in the "real world" who is registered with Teladoc Health's network. Teladoc Health's business model can be compared with Uber, the difference being that the service providers aren't drivers, but freelance medical professionals. As elsewhere, the name of the game is patient volume: the platform with the largest patient volume will also have the most doctors. The market potential is huge and all patient data ends up in Teladoc Health's own electronic patient records.

The mega deal: Teladoc and Livongo

On August 5, 2020, the news broke that Teladoc Health was acquiring Livongo in a stock and cash deal valued at USD 18.5 bn, making it the largest transaction to date in the digital health space. Under the terms of the deal, which has already been approved by the boards of both companies, Livongo shareholders would receive 0.592 Teladoc Health shares plus USD 11.33 in cash for each share of Livongo they own. Once the transaction is consummated, the former Livongo shareholders will own approximately 42% of the new entity's total shares outstanding.

Virtual care is made for chronic diseases

Chronic diseases represent an even larger potential market. Treating chronic disease is not about providing immediate care on demand for acute symptoms; rather, it entails a long-term relationship with a patient, providing reliable treatment for a disease such as diabetes. Chronic diseases account for 80% of total healthcare costs and that represents about 10% of global GDP. This is the market that Livongo has set its sights on. Initially focused on the diabetes market, Livongo has since expanded into other chronic disease areas that are closely related to diabetes, such as hypertension and obesity. "Mental health" is another large market targeted by both companies and they already offer their own particular solutions. Even more important than the potential market size of virtual care is the potential it has to improve treatment quality tremendously while reducing costs at the same time. In no other market the advantages of digital solutions can be leveraged so effectively as in chronic care: Patients can be monitored and receive care around the clock, no matter where they are. Virtual patient management has undeniable advantages over the prevailing methods where medical specialists often see their patients in a face-to-face setting only once or twice a year.

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Chances of success are good with support from investors

It takes a lot of explaining and convincing and, even more so, money to effect changes in the mammoth healthcare system. Investors need to believe in the successful outcome of the company's strategy, achieving market dominance in the long run. They need to see the path that will lead to that goal. In the case of Teladoc Health, the addressable market is huge in size. As long as Teladoc Health's management presents a convincing case that it is right on track, the amount of funds that it can draw from investors could easily eclipse the capital-raising capabilities of much larger corporations. Tesla has succeeded in doing this far better than any other company today. That is why it has been able to finance and complete huge preparatory projects while long-established automobile manufacturers found themselves bound by the rusty chains of the old economy.

Wake-up call for large US hospital chain operators

A big question is what other stakeholders in the healthcare system will do. Time is running out for the hospitals and their competitive advantages should be levered to establish virtual channels for providing medical services that are seamlessly integrated into existing pool of physical assets and resources. Existing players already have the required physical components: the doctors, the networks with the insurers, the actual infrastructure, a strong local footing and the trust of the local community. Some of today's healthcare providers also have valuable brands with international reputations, Memorial Sloan Kettering Cancer Center, for example. This means they could very well enlarge their addressable market well beyond their current reach. American Well (Amwell), one of Teladoc Health's competitors, could play a key role in doing so. The company is moving down a different path and sticking firmly to its role as a "neutral software vendor" whose solutions enable established hospital chains and even insurers to offer virtual care solutions. Amwell could certainly benefit from the current situation, then, once hospital operators realize how serious the situation is.

At any rate, quick action is called for because even deeply embedded competitive advantages can quickly dissolve amid a wave of digital innovation. For example, Teladoc Health added another key component to its repertoire when it acquired Best Doctors in the summer of 2017, a virtual service offering of international key opinion leaders and medical specialists covering the full spectrum of healthcare needs who provide expert second opinions, for example regarding important clinical decisions concerning complex cancer treatment. Teladoc Health also has the financial wherewithal to attract outside talents and deploy them exclusively within its proprietary network. Teladoc has been active on the software front, too, having acquired InTouch Technologies at the beginning of the year, the only relevant rival to Amwell, for a bargain price of USD 155 mn. Today, after the outbreak of COVID-19, that same transaction would probably carry a price tag of more than USD 1 bn.

The race has definitely been launched, but the winner is (still) unknown

Teladoc Health's management has done everything right so far and demonstrated strategic foresight on more than one occasion. If its management is also successful in convincing investors that its plans are viable and executable, the amount of capital that it could raise will be almost unlimited, whereas other healthcare system stakeholders will still be stuck in the old economy. A key factor will be the insurers and how active a role they play on the competitive field and offer their own comparable products. Teladoc Health's business model is, however, perfectly aligned with one of key demands of payers: better clinical outcomes, lower costs. Insurance companies and the patients both stand to benefit when this demand is met. Hospital operators hold their future in their own hands. Other sectors of the economy offer good examples of what happens when the challenge of a digital pioneer like Amazon is not taken seriously. Company leaders are well-advised to detach themselves temporarily from the corsets of the old economy and the capital market in order to ensure their longer-term survival.

Teladoc Health's upside potential is larger than ever

Teladoc Health's share price will likely be volatile for some time to come, but its investment case is more attractive than ever. All ingredients for a successful story are already in place. With the support of the investment community, Teladoc Health could become the "Amazon of healthcare". The company would not only be producing most of digital health services it provides in-house, it would also be managing and directing patient flows through collaboration agreements with established care providers and "collecting tolls" like Apple does with its business model. Teladoc Health's management has demonstrated very strong strategic planning and execution skills. It could be the one of the tech giants that eventually enters the scene. After all, Alphabet/Google, Apple and Microsoft have already invested billions in the healthcare sector projects – but they have very little to show for it so far. And yet the prospect of modernizing a sector that represents more than 12% of global GDP is very compelling. Any one of these tech giants could use their petty cash to take over Teladoc Health. The path ahead remains very exciting.

Fund facts

Investment manager	Bellevue Asset Management
Custodian	RBC Investor Services, Luxembourg
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Countries of distribution	Luxembourg, Switzerland, Germany, Austria, Spain, Singapore (restricted)
Volume (as of 07/31/2020)	USD 585.0 mn
Benchmark	–
NAV calculation	Daily "forward pricing"
Management fee	1.60% (B-shares)
ISIN	LU1811047593
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