Unlocking Aleres Potential

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by Igor Golalic

of Diamond Hill Capital Management

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Health care has historically been a good business, especially in the United States. Investors like to invest in good businesses and will usually pay a premium for those that generate stable, predictable, and excess returns or any combination thereof. There are certain characteristics that create an environment within which such businesses can prosper – higher barriers to entry, sticky customer base, secular growth prospects, low capital intensity, and lack of credible substitutes. These characteristics usually catch the eye of seasoned investors, such that market valuations tend to reflect those findings. What if there was a health care company that could check most of the boxes of a good business but had camouflaged itself as a bad business based on suboptimal historical management decisions? A company that generates visceral negative reaction among Wall Street analysts to a point that it is not trusted or listened to, even when what it says makes sense? A company whose complex set of financials, covered with one-offs and adjustments, makes it difficult to discern if it really is a good business?

This is the predicament that we found Alere, Inc. (ALR) in three years ago when we became interested in the company. Trading at 0.8 times book value and six times cash flow, the stock offered an intriguing valuation relative to its peers. What was even more interesting was that this was a company with technologies that seemed to be the best fit for the changing landscape of health care. With an emphasis on point-of-care, rapid-testing diagnostics, Alere appeared to have solutions for the most pressing problem in the U.S. health care system – cost management of chronic care expenditures. Alere had the diagnostic products to bend the cost curve in cardiovascular, diabetes, and infectious disease settings among other areas. The company also had products that would put the power in the hands of the user, further offering prospects for conservation of health care dollars and enabling their products to be sold more easily.

Why would such a company trade at a 40% discount to its peers? We believe the primary reason was the management team, which paid little attention to the stewardship of the capital entrusted to it. Management looked in the right direction but paid no attention to whom it would trample to get where it wanted to go, including its own shareholders. Then CEO, Ron Zwanzinger, built the company on the back of several acquisitions that fit his vision of where health care was going. Mr. Zwanzinger was capable in that regard – he saw the Accountable Care Organization (ACO) as the future of health care in the U.S., and he built a portfolio of tools to respond to ACO's needs. The introduction of Obamacare enabled this scenario to unfold, in some ways validating his views. However, Mr. Zwanzinger did not worry about the price he had to pay to get what he wanted. The company executed a number of expensive deals from 2006 to 2010, buying assets that would fit with its Connected Health strategy and spending close to $2 billion in the process. The largest of those deals was the purchase of Matria Healthcare for $900 million in 2008, which was then completely written off only two years later. This thirst for the next great asset continued into 2013 and eventually saddled the company with more than $3.5 billion in long-term debt (5.5 times EBITDA), yielding little in terms of marginal operating income. Not surprisingly, management did not focus enough on having sound production processes while on its merger and acquisition binge, which prompted several product recalls. Investors became disenchanted, which ultimately led to a revolt of sorts and the exit of top management earlier this year.

Today, Alere is at a crossroads, but it is our view that the future should be bright. With the departure of the previous management team, the doors leading toward value creation have finally appeared. There is more than one so the Board has to carefully weigh which one it decides to enter. One door leads toward a potential sale, involving potentially faster value realization as represented by the $46 per share offer that former CEO Mr. Zwanzinger proposed in mid-September. Another door leads toward a major restructuring of the business and a slower but potentially more rewarding path of value creation if executed correctly. It is our analysis of the prospects for the latter that gives us the confidence to project attractive returns for the shares going forward.

Alere's core business exhibits characteristics that we want to see in companies in which we invest. The company has first-in-class technologies that deal with crucial aspects of health care delivery including prevention, testing, monitoring, and outcomes. Alere also offers diagnostics that lead health care practitioners to make more informed decisions in the areas of coronary heart disease, heart failure,

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dyslipidemia, diabetes, various infectious diseases, respiratory, and women's health, ultimately leading towards better outcomes. This market is a $5-6 billion faster-growing subset of the $45 billion global diagnostics market, which we believe should yield 5-7% growth in the coming years. Accuracy, ease-of-use, and connectivity are some of the features that clients are increasingly willing to pay for, and Alere has products that fit these needs, the largest U.S. infrastructure to deliver those products, and a global reach with 40% of sales from overseas. Alere's new molecular testing platform, *Alere i*, separates it further from competitors in terms of future prospects and lowers potential risks from substitutes. Customers prefer to stay with one testing platform at point-of-care because they develop a trust and comfort with it over time. These are all potential signs of an attractive business. Finally, some of the best capital allocators in the health care industry are in this market, including Abbott Laboratories, Danaher Corp., and Roche Holding AG, providing another signpost that the point-of-care diagnostics business is attractive for the long-term.

In order to realize Alere's potential going forward, the new management team needs to focus on addressing two of the company's weaknesses – the overall cost structure and debt-laden balance sheet. We believe the business portfolio needs to be scaled down, with the sale of certain businesses, including Toxicology and Health Management, being a priority. This should allow for a tax-efficient deleveraging of the balance sheet. Interest savings from those sales would yield valuable resources for reinvestment into new technologies in the core point-of-care business. We estimate that Alere's operating cost structure could be streamlined by close to $100 million potentially adding $0.85 per share to a normalized earnings base of $2.25-2.40. Stepping away from the Connected Health initiative would save the company $40 million annually. We estimate another $40-45 million in savings by streamlining the manufacturing footprint from 35 facilities currently to a more reasonable number for a company with $2.4 billion in diagnostic revenues. The rest of the $100 million in savings could come by further streamlining the G&A functions. This leads us to believe that the real normalized earnings base off which the company could generate double-digit growth is $3.10-3.25 per share. A directional change in leverage prospects would tell investors that there is less financial risk as well, which should be rewarded with an improved market valuation. We estimate that a range of $53-56 per share would represent the proper valuation for the stock post the restructuring.

The risk associated with executing this strategy involves the culture and morale within the organization, which could suffer when faced with such a complex undertaking. Mr. Zwanzinger's offer at the time represented a 30% premium to the 30-day average stock price. Even though the Board has questioned where his financing would come from, it has a fiduciary responsibility to shareholders to consider every bona fide offer and weigh that offer versus its projection of the company's value. However, the latter should reflect all of the risks involved in realizing that value, including the aforementioned risks involved in a turnaround. If Mr. Zwanzinger's offer passes that bona fide test, then it should be considered. As shareholders, we view Mr. Zwanzinger's offer as a welcome distraction. It provides a confirmation of sorts that the underlying potential of the business is there, which we also see in our own estimate of the company's intrinsic value.

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