DaVita Inc. Q3 2021 Earnings Call

October 28, 2021
5:00 PM EDT

Jim Gustafson, DaVita Inc. – VP, Investor Relations
Thank you, and welcome, everyone, to our third quarter conference call. We appreciate your continued interest in our company. I'm Jim Gustafson, Vice President of Investor Relations. And joining me today are Javier Rodriguez, our CEO, and Joel Ackerman, our CFO. Please note that during this call, we may make forward-looking statements within the meaning of federal securities laws. All of these statements are subject to known and unknown risks and uncertainties that could cause the actual results to differ materially from those described in the forward-looking statements. For further details concerning these risks and uncertainties, please refer to our third quarter earnings press release and our SEC filings, including our most recent annual report on Form 10-K and subsequent quarterly reports on Form 10-Q and any subsequent filings that we may make with the SEC. Our forward-looking statements are based upon information currently available to us, and we do not intend and undertake no duty to update these statements except as may be required by law. Additionally, we'd like to remind you that during this call, we will discuss some non-GAAP financial measures. A reconciliation of these non-GAAP measures to the most comparable GAAP financial measures is included in our earnings press release furnished to the SEC and available on our website. I will now turn the call over to Javier Rodriguez.

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
Thank you, Jim, and good afternoon. Q3 was another strong quarter for DaVita in the face of a challenging operating environment. Despite another rise in COVID case counts across the United States and an increasingly challenging labor market, we continue to provide quality of care to our patients and execute on our strategic objectives.

I want to begin my remarks by highlighting an exciting milestone. We surpassed 15% of our patients dialyzing at home. This means that approximately 30,000 of our patients received a clinical and lifestyle benefits of home dialysis. As we've explained before, to be sustainable provider of home dialysis, it requires a comprehensive infrastructure, including convenient and easy access to a home center for training sessions and recurring visits with our care teams. Our current network of centers provides that easy access, such that 80% of our dialysis patients live within 10 miles of the DaVita home center. In addition, we continue to innovate on our platform to help make home dialysis an easier choice for patients and their physicians and to extend the duration on home dialysis once patients have made that choice. A few highlights of note. First, we recently rolled out an enhanced education program along with supporting technology for our new patients to ensure that they receive timely and comprehensive modality education, which is tailored to each patient's individual needs. We also continue to work on additional enhancements and customization to our education process for different communities such as Black and Hispanic patients to improve their chance of selecting this modality and therefore, improve health equity; second, we developed a patient portal and telemedicine platform that supports remote monitoring and communications between DaVita caregivers, our nephrologist partners and our home patients; third, we developed a team of industry-leading home physicians to create an expert network, which works closely with practicing physicians and practice leaders to help them understand the benefits of home modalities, troubleshooting complex clinical issues and elevate their home clinical skills. Last, we're testing out our AI and other technology to optimize PD prescription, alerting physicians in real time when an update prescription might be needed. We will discuss the strategic advantages of our platform in greater detail on November 16 on our virtual Capital Markets Day.

On to our Q3 results. Our business model continues to prove resilient in face of operating challenges. Q3 operating income grew approximately 9% year-over-year and adjusted earnings per share grew by more than 31% over the same period. However, the ongoing COVID pandemic continues to take its toll on too many human lives in the world at large and amongst our patients. Across the broad U.S. population, the current surge driven by the Delta variant appears to have peaked in early September with new case counts reaching approximately 2/3 of the peak during the past winter. Fortunately, within our dialysis patient population, the new case counts peaked approximately 1/3 of the winter peak and mortality rates were relatively lower, likely due to the vaccination rates amongst our patients. Incremental mortality increased from fewer than 500 in Q2 to approximately 2,000 in Q3. After quarter end, COVID infections continue to decline with our new case count during the week ending October 16, down by approximately 60% relative to the recent Delta peak. Switching to vaccines. Approximately 73% of our patients have now been vaccinated. In addition, we've started to roll out vaccine boosters for eligible patients in accordance with CDC guidelines. We're hopeful that any future COVID surges and breakthrough infections will be more limited relative to what we saw in the peak of last winter.

Shifting to cost. Cost management continues to be strong in the quarter, although we are facing the same competitive dynamics in the market for health care workers as other companies have mentioned. Despite these challenges, I'm pleased with how our frontline leadership team has been responding. It has long been a key part of our mission to be

the employer of choice. How we live this aspect of our mission has been evident throughout the pandemic, as our team has retained relentless focus on the safety and care of our patients as well as one another. As we have discussed in past calls, we continue to offer a safe and fulfilling work environment and have provided incremental pay and benefits to help our frontline caregivers during this challenging time. These efforts are ongoing. Given the current environment, we expect to provide our teammates with higher annual compensation increases than in typical years. This will put additional pressure on our cost structure, but we believe this will help us attract and retain the talent needed to achieve our long-term objectives. Just as critical and aligned with our mission and build on our history of investing in our people.

Finally, I would like to say a few words about Integrated Kidney Care or IKC. Last quarter, we shared details on our planned investment in IKC and long-term opportunity this creates for patients, payers and our shareholders. At the end of Q3, we now have over 22,000 patients in some form of integrated care arrangements, representing $1.7 billion of value-based care contracts. Next year, we expect to approximately double the size of our IKC business, driven primarily by our participation in the federal government's new CKCC program. While it is still early and contingent on successful execution, we believe that the investing in IKC represents a new and potentially meaningful earnings opportunity for us in the coming years. This is another area we plan to discuss in detail at our upcoming virtual Capital Markets Day. With that, I will turn it over to Joel for more details on the quarter.

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Thanks, Javier. Despite the operating challenges Javier referenced, we delivered another quarter of strong results. Operating income was $475 million and earnings per share was $2.36. Our Q3 results include a net COVID headwind of approximately $55 million, an increase relative to the quarterly impact that we experienced in the first half of the year. As Javier mentioned, the latest COVID surge resulted in excess mortality in the quarter of approximately 2,000 compared to fewer than 500 in Q2. We're also anticipating the mortality in Q4 to be higher than it was in Q2, although we've seen a decrease in the last few weeks that we hope continues. Our current view of the OI impact of COVID for the year is worse by approximately $40 million compared to our expectations from last quarter. For 2021, we now expect a total net COVID impact of approximately $210 million. Treatments per day were down by 536 or 0.6% in Q3 compared to Q2. The primary headwind was the increase in our estimated excess mortalities and higher missed treatments as a result of the COVID surge. In addition, the quarter had a higher ratio of Tuesday, Thursdays, Saturdays, which lowered treatments per day for the quarter by approximately 300. In light of the current Delta surge and the compounding impact of mortalities on our year-over-year growth, we believe that the timing of a return to positive NAG will now be delayed into 2022. Revenue per treatment was essentially flat quarter-over-quarter. Patient care cost per treatment was up approximately $5 quarter-over-quarter primarily due to higher teammate compensation and benefit expenses. This is the result of higher wages, additional training costs associated with an increase in our new hires and seasonality in health care benefit expenses, which we expect to continue into Q4. Our Integrated Kidney Care business saw an improvement in its operating loss in the quarter, which is due primarily to positive prior period development in our special needs plan. We continue to expect increased cost in Q4, especially in our projected CKCC markets as we ramp up staffing in preparation for 2022. DSOs for our U.S. dialysis and lab business increased by approximately 3 days quarter-over-quarter primarily due to fluctuations in the timing of billing and collections. Other loss for the quarter was $7.6 million primarily due to a $9 million decline in the mark-to-market of our investment in Miromatrix. The value of this investment at quarter end was $14 million.

Now turning to some updates for the rest of the year and beyond. As I mentioned on the Q2 earnings call, we excluded any impact of a significant surge in COVID from the Delta variant in our revised guidance, but noted that a wider range of outcomes was possible depending in part on how a fourth surge would develop. Now that we've seen the impact of the Delta surge, we are increasing our estimate of COVID impact for the year by $40 million. Given where we are in the year, we are now incorporating this COVID impact into our revised adjusted OI guidance of $1.76 billion to $1.81 billion. We are also narrowing our guidance for adjusted EPS to $8.80 to $9.15 per share, and we are maintaining our free cash flow guidance of $1 billion to $1.2 billion, although there is some chance that our free cash flow may fall below the bottom end of the range, depending on the timing of our DSO recovery. Our revised OI guidance implies a decline in our Q4 financial performance relative to Q3. This is partially explained by the incremental COVID mortality impact and by expected higher salaries and wages for existing frontline teammates. Our guidance anticipates Q4 operating income to be negatively impacted by approximately $75 million of seasonally high or onetime items, including certain compensation expenses, elevated training costs, higher health benefit expenses and G&A.

Looking ahead to 2022, the 3 expected headwinds I talked about on the Q2 earnings call remain. As a reminder, we expect to have added expense related to DaVita's portion of the industry effort to counter the ballot initiative in California. We anticipate a year-over-year incremental investment in the range of $50 million as we continue to grow our IKC business. And we will also begin depreciating our new clinical IT platform, which we expect to be approximately $40 million.

A few additional things to help you with our thinking about 2022. COVID remains a big uncertainty. We are anticipating the end of the temporary sequestration suspension, which would be a $70 million headwind for the full year. We also expect that some of the costs that spiked during COVID, in particular, PPE may not return as quickly to pre-COVID levels due to the challenges of the global supply chain. Finally, COVID's impact on mortality next year remains a large swing factor. Another winter surge would negatively impact treatment volume and could delay the timing of achieving positive NAG. However, if the recent surge proves to be the last significant COVID surge, then we would expect a tailwind from lower than typical mortality which could result in treatment growth higher than pre-COVID level. In 2022, we expect net labor costs will increase more than in typical years as a result of market pressures. Our current estimate is a net headwind of $50 million to $75 million. We expect to offset a significant amount of these incremental costs with continuing MA penetration growth above historical levels and strong management of non-labor patient care costs. From an operating income growth perspective, we expect 2022 will be a transition year with some significant but largely temporary headwinds to get through, after which we expect our platform to continue to support strong profit growth. While the range of potential outcomes for 2022 is broad, a reasonable scenario could result in an OI decline of $150 million from our 2021 guidance. This includes the impact from the expected ballot initiative, IKC and the increased depreciation. This scenario also includes a modest headwind from COVID, although there are scenarios where the impact of COVID could be significantly worse.

Looking forward to 2023, we anticipate a reversal of the net impact of these 2022 headwinds plus incremental operating income growth such that we expect 2023 operating income to show a low to mid-single-digit CAGR from the midpoint of our updated 2021 guidance, which would be in line with the multiyear outlook we have shared historically. We expect this to be the result of the lack of ballot initiative related costs, the recognition of savings in IKC, an improved COVID situation and continued growth of the core business. We'll have more to say about long-term guidance at our Capital Markets Day in a couple of weeks.

Finally, during the third quarter, we repurchased 2.7 million shares of our stock and in October to date, we repurchased an additional 1.2 million shares. Operator, please open the call for Q&A.

Operator
Justin Lake from Wolfe Research.

Justin Lake, Wolfe Research
Let's start on the fourth quarter. You're talking about -- it sounds like most of the $40 million of incremental COVID costs are actually happening in the fourth quarter, is that correct?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Most, yes, but there was some in Q3 as well. So I would think of Q3 is $55 million. And if you take the number we gave for COVID for the full year, what would be left is about $85 million for Q4.

Justin Lake, Wolfe Research
Okay. And then can you help us on the mortality side, what you're seeing there? And how much of that $40 million or maybe we've been talking about the $75 million that you talked about in terms of higher costs, how much of that's coming from mortality?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes. So what we've seen in mortality is a pickup in Q3 to about 2,000 excess mortality. Remember, we were below 500 in Q2. And there's no doubt that Delta surge came on bigger than we expected, and we expect that to continue in to Q4 a bit. So if you look at -- if you're trying to triangulate in on growth, what you see for the quarter, Q3 over Q2 is treatment growth per day, that's down a bit. That's largely the result of the excess mortality. There are also -- there were more Tuesday, Thursday, Saturdays and Monday, Wednesday, Fridays, and that was about a 300 treatment per day headwind in the quarter as well. So that's the -- those are the numbers behind it. In terms of the financial impact from COVID, what you're seeing is definitely, the excess mortality that hits in Q3, it hits even harder in Q4.

You're also seeing some increase in missed treatments, which we've seen in prior surges, and we're anticipating in Q4 again. And then you also see some increased labor costs associated with cohorting and stuff like that. So that's how I'd lay out the impact of mortality and other things on COVID in Q3 and Q4.

Justin Lake, Wolfe Research
Okay. And then in terms of the $75 million, is any of that -- it sounded like some portion of that's one time. So is this not that the kind of implied Q4 OI, is that a reasonable run rate? Or is there to kind of jump off of? Or is there some onetime costs within that $75 million that kind of jump you off a bigger base?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes. So I would think of the $75 million is coming in 2 forms, either onetime or seasonal pickups. The onetime things I'd call out are some comp bonus type stuff, and then training is up when we hire new teammates that tends to lead to a higher training number. So those are the onetime things in the $75 million and then there are some seasonal items. There's a seasonal benefit impact in Q4 and also a seasonal increase G&A. Those are things we tend to see in most years, and they're a bit exaggerated this year as a result of the patterns resulting from COVID. But to get to your fundamental question of what's a good jumping off point for next year, I think the full year number for 2021 is a reasonable baseline off of which to jump off for next year. If you took Q4 and adjusted for the $75 million, you'd get to about the same spot.

Justin Lake, Wolfe Research
Got it. And if I could squeeze in one more. You talked out to 2023, and a lot of this stuff makes sense in terms of kind of transitory costs. But you talked about 2 pieces here, IKC savings, right? So you talked about 2022, you're going to have $50 million of incremental losses. How much better did IKC -- what's the tailwind in '23 there? And then you talked about improved COVID. Can you talk about the tailwind there in terms of sizing that? That would be really helpful.

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Sure. So I'll start with the caveat that 2023 is a long way away, and we're even cautious about talking about '22 given the uncertainty. So I wouldn't think of this as guidance, but just some reasonable estimates to help you think things through. So on IKC, I think a $50 million reversal of the headwind we're seeing in '22 is a reasonable way to think about '23. So basically winding up in '23 about where we are in '21. COVID is really, really hard to think about. That said, if you assume that COVID disappears at some point next year, I think the right way to think about it, and now I'm bridging basically from '21 to '23 is we've got a $70 million sequestration suspension that becomes a tailwind, right? We're getting all of that in '21. That goes away in '22 and stays away forever. So there's a $70 million headwind there. We've got roughly a comparable number of net expenses associated with COVID. Think about labor, think about the increased spend on PPE with some offset related to T&E primarily. And that net number is a $70 million number today. So as that dissipates, what you've really got is effectively a tailwind from that, that offsets the headwind from sequestration and what you're left with is mortality. And mortality today is, on a run rate basis, somewhere in the $240 million number. And what we would expect is over some long period of time, 4, 5, 6, 7 years for that number to go to zero. So as that $240 million headwind we've got today dissipates, then you would see that coming back into earnings over time. So that's the COVID story.

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
And then I'll just add one thing. As you're finishing your bridge, Justin, don't forget that there's a $60 million California ballot that's going to be in '22 -- sorry, yes, in '22, they won't be in '23. And that's another helpful number to bridge to.

Operator
Kevin Fischbeck from Bank of America.

Kevin Fischbeck, BofA Securities
Great. I want to maybe follow up on that last question. That mortality number, Joel, I guess you're talking about 4 to maybe 7 years, getting that back. I guess that might be a little bit longer than I might have thought of a time period to think about that number coming back. I mean why wouldn't it be something more like 3 years rather than 4 to 7?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes. So Kevin, first of all, you might be right. And I think there's likely to be a tail to it, right? And we don't know how long that tail is but there is certainly a very reasonable scenario where most of that bounce back comes out -- comes back quicker, certainly quicker than 7 years and potentially quicker than 4 years. So it probably doesn't come back evenly over whatever number you choose, and I think there's reasonable logic to say you get more early on in that period and the tail gets a little thin towards the end. So I'd say you could be right in terms of getting most of it in 3 years.

Kevin Fischbeck, BofA Securities
Okay. That's helpful. And then I think you mentioned that because of the COVID spike, you now don't expect NAG to get back to positive until next year. I forget what -- I guess, maybe I don't remember if you said that you thought it was going to happen by year-end or not. But I guess is that how we should think about it that you had the last spike in Q1 and then you thought you might have been able to get back to positive by year-end? And now that we have one in Q3, maybe 3 quarters later, we'll get to positive NAG. Is that the right waiting period or?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes, I think that's a good start for thinking about it. Although the size of the spike also impacts how long it takes us to get back to a positive NAG because if the spike is lower, our natural growth can kind of overcome that in a shorter period of time. As I -- as I've said, I think, on prior calls, I found thinking about quarter-over-quarter treatment per day patterns to be a much easier way to think about what's going to happen to our volumes and then ultimately, revenue over the next few years. NAG can be a little bit of a clunky number when in times like this, where there's so much volatility.

Kevin Fischbeck, BofA Securities
Okay. And then maybe last question, you mentioned kind of doubling the size of IKC. And it sounds like a big portion of that was the government program. I guess is there a way to break out your view about growth in MA versus the new program?

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
Sure. Well, right now, what we're seeing is that more patients are reviewing their insurance and selecting MA. And so if you were to look at the broader population, I think the last number I saw in non-kidney is around 43% of patients are choosing MA. Our number is now close – getting close to that. We're roughly around 41%. And so as MA grows, of course, that's likely to be a big feeder into the risk because those plans are coming to us and wanting to contract.
As it relates to the government, we are in the final stages here of sizing the practices that are really going to enroll and therefore, attribute their patient. But our estimates have been both doubling roughly from what we have now, and we will give you information as it plays out.

Kevin Fischbeck, BofA Securities
Okay. And again, so if MA is already kind of at penetration, the doubling then is from just moving contracts with MA plans that you already have from a fee-for-service to an IKC-type structure?

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
Yes, yes. So more plans are wanting to have IKC-type structures. Correct.

Kevin Fischbeck, BofA Securities
Okay. And then just last question on this then. Is there anything different? Are these contracts coming together quickly? So if we think about timing of all this stuff, this year is the first year, so I could see a lot of companies dragging their feet. Would you expect to largely have penetrated that contract opportunity within MA plans? Or what percentage of your MA contracts would be this type of arrangement next year? And when will we expect to see the vast majority can be that type of arrangement?

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
Yes. I think it's specific by payer. It's quite customized. As we all know, payers have different strategies and different cadences as to where they put their focus. Again, the range of contracts and structures from anywhere from fee-for-service, pay to performance, gain share, shared risk, all the way to full risk, is basically customized by payer.
So the cadence is really customized. We're ready to go. And so we're talking to them, and there's nothing really interesting to report on timing per se. It's steady and constant.

Kevin Fischbeck, BofA Securities
Okay. So it's not like a huge jump next year. It's constant growth in that -- increase in that number is the way to think about it?

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
We're not forecasting any drastic change.

Operator
Our next question comes from Pito Chickering from Deutsche Bank.

Pito Chickering, Deutsche Bank
Follow-up to Justin's questions. And forgive me, there are a lot of numbers sort of on this call. If we take the midpoint of OI guidance for 2021 and put a 4% CAGR on that, for 2023, you get to that $1.93 billion of operating income. How much of that comes from IKC versus core dialysis? And how does IKC change the low to mid-single-digit CAGR of OI going forward?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes. So in terms of how much of the OI in '23 comes from IKC, again, with all the caveats about uncertainty and everything else, you're really going to see no change in OI and IKC from '21 to '23. That's -- again, that's a reasonable scenario from where we are. So if you think about OI growth, total OI growth '21 to '23, you basically see a zero in that scenario from IKC.

Pito Chickering, Deutsche Bank
Okay. So that sort of 4% OI growth sort of CAGR for the next years, that 100% is coming from core dialysis at this point? And even the...

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes. I think, Pito, the right way to think about it is it's largely coming from core dialysis. There -- we've called out a bunch of headwinds and tailwinds. The ones from ballots and IKC kind of offset each other, so they're a net zero. The depreciation from our new clinical IT system stays with us, and you'll have that tailwind from COVID.

Pito Chickering, Deutsche Bank
Okay. But -- so let me just start work with these numbers for a second. If I take, again, the OI from this year, that's embedding $120 million of losses from IKC. You're saying that by 2023, we'll still run $120 million of losses through the P&L on the IKC?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Right. What we're effectively saying is the $120 million in 2021 goes to $170 million next year. And that's one of the big headwinds for next year, and that reverses itself in '23.

Pito Chickering, Deutsche Bank
Okay. So the full $170 million reverses or just the $50 million reverses? I mean, just the...

Joel Ackerman, DaVita Inc. - CFO & Treasurer
No, just the $50 million.

Pito Chickering, Deutsche Bank
Okay. Got it.

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Ultimately, our expectation would be the full $150 million would reverse itself and the business would become profitable, but it wouldn't happen all in '23.

Pito Chickering, Deutsche Bank
Okay. And then from a labor side, as you sort of think about 3Q and 4Q cost per treatment, how much of this is transitory from premium labor versus wage inflation, which can continue in 2022? And can you remind us sort of what your normal wage inflation was and kind of what we should be thinking about for 3Q and 4Q?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes. So the numbers in Q3 and Q4, there is some wage inflation, but where you're really going to start seeing that is next year. And I know I went through a lot of numbers quickly in the script. What we called out at the beginning of the call was a $50 million to $75 million net labor headwind next year. And that would be wages, it would be training and there could be potential offsets from benefits or productivity and stuff like that. But I think the right number for next year is a net headwind given the challenging labor environment of $50 million to $75 million.

Pito Chickering, Deutsche Bank
Okay. Fair enough. For IKC, will you plan to break out sort of the revenues and cost per patients at some point so we can help model out how that's tracking?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes. I think we're on a bit of a path to continue to create a disclosure package around IKC that will give shareholders the visibility they need into our progress.

Pito Chickering, Deutsche Bank
Okay. And then the last question for me. There's $1 billion of cash sitting on the balance sheet right now. How much cash do you guys need to run the core dialysis and now the new IKC that grows in 2022? And how much do we think about that going back into share repo at this point?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes. So I would think about us typically needing somewhere around $300 million of cash on the balance sheet just to run the business. I don't think that number will change significantly with IKC, we're not a regulated entity. We don't have statutory capital requirements.

Pito Chickering, Deutsche Bank
Okay. So that's fair to think about $700 million of excess cash being used for share repo sooner rather than later?

Joel Ackerman, DaVita Inc. - CFO & Treasurer
I'd say, yes, on the $700 million of excess cash, look, we clearly been buyers of the stock. We bought more than usual since the last earnings call. As we've said in the past, we're not agnostic on price. If we like the price, we will buy more.

Operator
Sarah James from Barclays.

Sarah James, Barclays
And I appreciate all of the color about '22 as a whole. But I'm hoping that you could give us a little bit more on the cadence of how the year will roll out. So some of those headwinds, are they starting at the beginning of the year or later on? And then on the labor cost side, we've heard some of the acute guys talking about labor costs improving in the back half of the year and I just wasn't sure if that's what you were anticipating in your guidance as well.

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Sure. So on labor timing, I don't think we have a particular view about the macro economy and the labor market and how that's going to play out. So I don't have anything to add there. IKC, I think you'll see a lot of that starting in the beginning of the year. You'll actually start seeing some of that in Q4, but it's certainly could build up over the course of the year. If the ballot initiative is similar to what we've seen historically, it plays out largely in Q3, although there can be pieces in other quarters. The depreciation number I've talked about is probably likely to be more of a back half of the year event. You might see some in Q2, but it will be back-end loaded. And COVID is complicated. It will -- the sequestration, assuming it goes away, will happen on 1/1, so there'll be a big hit related to that starting in January. How exactly the other costs roll out, hard to predict, although net-net, you'd probably see that improving as the year goes on, although not that big a number. And I'm not sure how to even help you with the mortality figure. Historically, even when mortality comes down, it still accumulates. Next year, if there is no winter wave and COVID overall begins to go away, I think you'd expect to see that starting to improve over the course of the year. I hope that helps.

Sarah James, Barclays
No, that's very helpful. And just one more here on labor. Can you give us any more color on where you're seeing that labor pressure most acutely? So is it in a certain skill level or type of position that you're seeing it? And then how material is that cluster of employee to your overall SWB expenses?

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
Sarah, I wish we could point to one, but the reality is, while it is more acute in certain geographies, it is very widespread and across most of our clinical teammates. And so it is wide and many geographies.

Operator
Our next caller is Lisa Clive from Bernstein.

Lisa Clive, Sanford C. Bernstein & Co
Two questions from me. Just on the wage inflation. So Medicare is obviously inevitably delayed in how their rate updates come through. Could you just give us some information on the rate adjusters in your private contracts? Is it similar to Medicare where they're set once a year and are looking at metrics that are somewhat backdated?
And then the second question, on integrated care, the $120 million of losses still in 2023. I'm just trying to understand this and really sort of thinking about scaling up that program. CKCC is obviously one major driver. How big do you envisage that program getting? And I suppose what does the ramp-up look like?

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
Let me grab the first part and then Joel can supplement. First, in case it's useful. Medicare has a basket update. And the way it's calculated is not looking at pure dialysis and what's happening to cost either retrospective or prospectively, rather, there's an economic firm that forecast inflation and then they subtract what they call a productivity adjustment, which, in essence, is a 10-year average that's trying to measure the efficiency of the economy. So as you can imagine, that's got some complexity. As it relates to the commercial business, the way it's done is usually through a negotiated way. And so every single one of them is negotiated individually and the timing tends to be effective whenever the contract was shy. And so if you think of a contract that was signed in February, usually, the annual escalator would be done in February of the next year. That's the most traditional way of doing it. Of course, there can be other ways that have a pay-for-performance or other mechanisms. But in general, that's how that works.

As it relates to your second question on CKCC, the short answer is we don't know. For right now, it's a CMMI pilot. And so it's authorized for 2 years. Of course, the intent to try it out and see if it's effective and if it works for the system and if we're doing well by the patients. And then I would assume that then Medicare would try to extend it. We try to think of a world where hopefully, you get to somewhere in that 30,000 patients in one way or another being through MA or a CMMI vehicle, but we will see.

Operator
And our next caller is Pito Chickering from Deutsche Bank.

Pito Chickering, Deutsche Bank
Just a follow-up here. I sort of want to go back to the IKC losses in 2023. I'm just struggling a little bit on $120 million of losses you guys are assuming that we'll have there. When the ESCO program, you guys been running was -- showed savings right out of the gate. Can you just help me understand why we'll still see $120 million in IKC 3 years out when ESCO is profitable on year 1?

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
Well, let me just grab the high level and then Joel, you can supplement with numbers. The best way to think of the ESCO is actually not that they were profitable, but what non-dialysis savings were actually quite good. But then, of course, you have to apply the operating model and then you have to load the G&A. And now in the models that we have, we also have to share with partners. And so that's how the numbers sort of trickles down. And you have to get to scale. And so a good way of thinking is that once you do all that and you go through all those iterations, you probably will get to a low single-digit OI number. And depending if you're grabbing non-dialysis, I would think of it somewhere in the 3-ish percent or so. If you're thinking of the entire number, it's 1.5% or so because it's roughly half

dialysis and half the other non-dialysis costs. But in the ESCOs, when you fully load them, we didn't make money, rather people were measuring whether it was effective at reducing non-dialysis costs.

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes. Pito, the thing I'd add there, Javier paints the kind of the end game there. The question is how do you get there? And the thing I would remind you is in -- the costs all come upfront. You're paying for the model of care to deliver the savings, you're paying for the G&A, you're building capabilities. The revenue is delayed, and we won't see any revenue in year 1. Year 2, we'll start to see some but the number will grow over time as the effectiveness of the shared savings continues to grow. So there is not a good matching of revenue and cost, especially in years. So part of it is the investment and the scale that Javier talked about. Part of it is the delay in the revenue.

Operator
Gary Taylor from Cowen.

Gary Taylor, Cowen and Company
Just 3 quick ones. Joel, did you have to give us the quarterly step-up in depreciation? You've mentioned a few times, but I don't know that I have it quantified for the system.

Joel Ackerman, DaVita Inc. - CFO & Treasurer
Yes, it's $40 million is the annualized number, Gary. And it will probably start sometime in Q2, but you'll see most of it in Q3 and Q4.

Gary Taylor, Cowen and Company
Okay. Just making a note. The other is anything happening on -- you cited commercial -- favorable commercial mix a couple of quarters in a row. Is there anything happening there besides the Medicare mortality that's changing that, that's worth calling out?

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
No. I think there's been a very much an appreciation during the pandemic that people want to keep their insurance and they value it. And so it's been very resilient and constant.

Gary Taylor, Cowen and Company
Got it. And then my last one is going back to Joel, going back to 2023. So if we take 2021, we walk it down $150 million, but then we're getting back to low to mid-single-digit CAGR and towards $1.9 billion and change for 2023. That's about a $300 million step up from '22 to '23. So the parts of that would be an incremental $50 million IKC, $60 million reduction in advocacy spend, some low to mid-single-digit organic and then the rest of that hole would be some portion of this gross COVID mortality and direct expenses coming down? Is that the...

Joel Ackerman, DaVita Inc. - CFO & Treasurer
That's exactly right.

Operator
Lisa Clive from Bernstein.

Lisa Clive, Sanford C. Bernstein & Co
I just wanted to follow up on the private contracting. In terms of the structure of how the rate increases work, so if you have a say, 4-year contract, are the rate adjustments for all 4 years fully fixed at the outset? Or is there any ability for those rate adjustments to increase if there is higher inflation as you're clearly experiencing now? Or are they just fully set as a percentage increase, and that's that over the course of the contract?

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
Most of them are fixed, Lisa, some of them, you have to earn your way to them so they can fluctuate year-over-year depending on performance, but most of them are fixed.

Lisa Clive, Sanford C. Bernstein & Co
Okay. But they would vary based on performance, not on your underlying cost structure?

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
Correct. Sometimes you could have, of course, something that's linked to an index or something like that, but in general, it's defined and understood.

Operator
And at this time, I'm showing no further questions.

Javier Rodriguez, DaVita Inc. - CEO & Executive Director
Thank you, Michelle. Well, we've covered a lot. So let me just try to summarize as cleanly as I can, 3 takeaways. Number one, our core business is strong; number two, 2022, we'll have a lot of temporary OI decreases that will correct back to historical OI in '23; and then point three, our teams are working really hard on innovation to deliver on the integrated care dream. We look forward to discussing our strategy in more detail on November 16 during our Capital Markets Day and talk to you then. Be well, everyone.