Why the Teladoc-Livongo Merger Makes Sense

I'm going to use this article by Richard Chu of Saga Partners as a jumping-off point:
https://richardchu97.substack.com/p/teladoc-and-livongo-a-merger-that

Basically, the short version of his bullish thesis for the Teladoc(NYSE:TDOC) - Livongo(NASDAQ:LVGO) merger is that it will disrupt the healthcare industry, which is currently built around treating diseases (particularly acute diseases, where most of healthcare spending occurs); by using new technology to significantly reduce overall healthcare costs, through: - prioritizing preventing diseases before they become serious (pre-medicine) VS treating them after they become serious, and

- online direct-to-consumer treatment (tele-medicine) VS physical visits to the doctor

The general idea is that preventative care is much cheaper for the overall healthcare system than treatment care, as suggested by the recent shift in regulation to favor Value-Based-Care (VBS) over Fee-For-Service (FFS). And as the pandemic has accelerated the shift to online, tele-medicine will also see more rapid adoption than previously anticipated.

In fewer words, they are the Amazon of the healthcare industry.

The merged entity will in general command total market share of the pre-medicine and tele-medicine sectors, which means that as the heathcare sector shifts towards these two developments, "Tela-vongo" might start to have more bargaining power over existing healthcare players (hospitals and insurance companies), and be able to usurp the massive healthcare TAM.

Anyway you can read his excellent article for the longform business rationale. I'm just going to focus on the financial aspects of the merger, and why I think it makes sense.

Teladoc	**2015**	**2016**	**2017**	**2018**	**2019**	***post-acq***	***fair value***	
revenue	77	123	233	417	553	*1,328*	*6,576*	495%
		60%	**89%**	**79%**	**33%**			
gross profit	-56	-91	-171	-289	-368			
		63%	88%	69%	27%			
admin	-54	-48	-79	-116	-157			
		-11%	65%	47%	35%			
marketing	-38	-60	-95	-144	-174			
		58%	58%	52%	21%			
research	-14	-21	-34	-54	-64			
		50%	62%	59%	19%			
net profit	-58	-74	-106	-97	-98			
		28%	43%	-8%	1%			
common stock	309	435	866	1434	1538	*18267*	*18267*	
		41%	99%	66%	7%			
debt	26	44	207	414	440			
		69%	370%	100%	6%			
capital	335	479	1073	1848	1978			
		43%	124%	72%	7%			
RevOE	25%	28%	27%	29%	36%	*7%*	*36%*	
		13%	**-5%**	**8%**	**24%**			
RevOIC	23%	26%	22%	23%	28%			
		12%	**-15%**	**4%**	**24%**			

I'm using pre-2020 numbers so as to measure performance on a pre-coronavirus (normalized) basis. As Teladoc has never been profitable pre-2020, I'm using Revenue Growth as the barometer for performance. As we can see, Revenue Growth has generally outpaced Expense Growth, meaning that it has been doing quite alright on the performance front.

However, Teladoc achieved this growth through making acquisitions rather than organically, i.e. a roll-up strategy. Hence, ROE or ROIC would be a more objective metric to measure performance. However, as Teladoc has never been profitable since listing, I have opted to use RevOE (Revenue on Equity) and RevOIC (Revenue on Invested Capital) as a crude proxy for ROE/ROIC.

As we can see, RevOE and RevOIC have both hovered around the 20%-30% range for the past 5 years, which at the very least implies that their acquisitions haven't yet been value-destructive. However, immediately post-merger the new entity's RevOE (and RevOIC, assuming all existing debt paid off) will drop to 7%. That means, for the RevOE to return to the pre-merger level of 36%, it will have to grow revenues to $6.576B, or 5x (495%) current post-merger revenues.

With the business rationale explained by Richard Chu above, I think 5x is feasible over the long-term. And that is before incorporating other bullish assumptions like scale advantages, which should improve ROE at a faster rate than RevOE. Any revenue growth beyond that would imply that the merger is value-accretive.

Please keep in mind that I have relied entirely on secondary sources for this back-of-the-envelope financial analysis, and have not yet done thorough research. I hope others who have more insight into the merger can contribute more than I have.