



# PRIVATE EQUITY AND HOSPITALS

*Providence Or Problem?*

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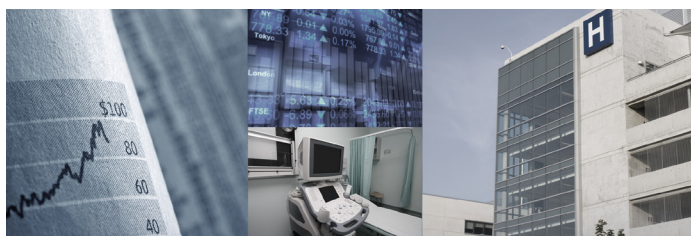
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## *Providence Or Problem?*

*An Advisen Special Report sponsored by OneBeacon Professional Insurance*

While there has been a dearth of merger and acquisition activity for the last two years, one sector has been booming: private equity investments into not-for-profit health care institu-



tions. The capital infusion has brought welcome relief to many hospitals, which had been brought to the brink by rising operating costs and diminished revenues. The new investors are keeping facilities open and hospital workers--often the largest workforce segment in many towns--employed. But the circling of private equity funds around not-for-profit

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hospitals has brought worries to others, including patient care advocates, concerned that quality care may take a back seat to profits.

This special report examines why investors are targeting not-for-profit hospitals, what future activity we can expect to see in this sector and what the ramifications are for hospital operations and patient care.

### **What's ailing america's not-for-profit hospitals**

The last decade has left many of America's not-for-profit hospitals in a condition more critical than that of their patients. Consider St. Vincent's Hospital-Manhattan: After 160 years of operation, the New York City hospital filed for bankruptcy in April 2010, owing creditors a reported \$1 billion<sup>1</sup>. It was the hospital's second bankruptcy filing in five years, and it was its last. Founded to serve the poor of the 19th century, it was shuttered by the cost of their care in the 21st century.

Like St. Vincent's, community hospitals across America have been caught in a deadly squeeze of higher costs and lower reimbursements, often caused by the community care they were established to provide. Uncompensated care--the total cost of bad debt and charity care--rose

*The precarious finances of not-for-profit hospitals have left many with insufficient capital to invest in patient technology*

to \$39.1 billion in 2009 from \$3.9 billion at not-for-profit hospitals in 1980, according to the American Hospital Association, even as the total number of community hospitals shrunk, from 5,828 to 5,008. Serving populations that were often uninsured or underinsured, these hospitals rely heavily on government support, which has been weakened. Reimbursement rates from Medicare and Medicaid are below the cost of care for those programs, helping underpayment by the government to community hospitals to reach \$36.5 billion in 2009<sup>2</sup>. As a result of all these factors, the percentage of not-for-profit hospitals with negative total margins hovers around 30 percent<sup>3</sup>.

Hospital administrators have tried a variety of approaches to manage the mess. There have been belt-tightenings, bankruptcy filings, and more. In the wake of the 2008-2009 credit crisis, many hospitals tried to ease the pain of what they owed by converting their variable-rate debt to fixed-rate structures or short-term bank loans. In its recent outlook report on not-for-profit health care providers, Standard & Poor's noted that while fixed-rate debt is more predictable, its higher cost raises other concerns. The agency also said that it will be watching hospital refinancing plans as the loans mature<sup>4</sup>.

The precarious finances of not-for-profit hospitals have left many with insufficient capital to invest in patient technology, efficiency measures and infrastructure needed for care now--and in the future. Many are ill-prepared to take on necessary risk within an Accountable Care Organization (ACO), the new structure created by U.S. health care reform that will bring together doctors and hospitals to deliver comprehensive care to Medicare beneficiaries. These financial shortcomings could cost them even more down the road because of the push to adopt other provisions of the health reform act, particularly electronic health records. Despite substantial incentives authorized by Congress, 55 percent of all hospitals expect to face penalties for failing to demonstrate meaningful use of electronic health records by 2015. The percentage rises to 66 percent among critical access hospitals<sup>5</sup>.

There will be other pressures on their finances. Medicaid reimbursements are expected to fall as states struggle to close their budget gaps. And payments from commercial insurers are likely to be lower as these businesses implement the Patient Protection and Affordable Care Act (PPACA), the U.S. health care reform law signed into law by President Barack Obama on March 23, 2010. The sweeping law requires insurers to expand their coverage of those with pre-existing conditions and equalize rates, even as they face greater competition for the healthiest Americans.

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The precarious state of not-for-profit hospitals has been duly noted by the rating agencies. Both Moody's and Fitch Ratings issued negative outlooks on the sector again this year. S&P was slightly more sanguine, noting that it had 43 upgrades and 32 downgrades among not-for-profit health care providers in 2010, the first time that upgrades had exceeded downgrades since 2006. Still, the agency cautioned against celebrations: "... we also do not believe those positive results are sustainable," it wrote, "and expect only relative rating stability in 2011." It sounded an even more pessimistic note for 2012 and beyond, saying that hospitals will face a weaker revenue environment brought on by declining inpatient utilization, a long-term decline in employer-based health insurance, and the fuller implementation of health care reform<sup>6</sup>.

### **Deal landscape: who's buying whom**

These financial troubles are a prescription for more radical change. While some not-for-profit hospitals are closing, many others are being sold to investor groups. According to the American Hospital Association, 998 community hospitals in the United States were investor-owned in 2009 (the most recent year for which statistics are available), compared with 2,918 non-government not-for-profit community hospitals<sup>7</sup>. The total number of community hospitals has fallen from 5,455 in 1989 to 5,008 in 2009, with the bulk of the decline coming from rural community hospitals: there were 2,497 in 1989 and just 1,997 in 2009<sup>8</sup>.

Buyers include some of the biggest names on Wall Street. Warburg Pincus LLC put \$300 million into backing RegionalCare Hospital Partners in 2009. RegionalCare bought four hospitals in 2010 and is set to acquire more this year. In February it signed a letter of intent to buy Landmark Health Systems Inc., the operator of two not-for-profit hospitals in Rhode Island. In March, it made an unsolicited offer for Cheyenne Regional Medical Center in Wyoming.

Meanwhile, Cerberus Capital Management LP has created a hospital acquisition arm called Steward Health Care System LLC. In 2010, Steward bought Caritas Christi Health Care, a six-hospital Roman Catholic health chain in Boston, for \$895 million. This year, it has already set its sights on a larger target: Miami-area hospital operator Jackson Health System, which would be a \$1.1 billion deal.

## The Deal Makers

Private Equity Firm	Vehicle	Deals Done
Blackstone Group	Vanguard Health Systems	Owns hospitals in Arizona, Illinois, Massachusetts, Michigan and Texas. Holdings include the Arizona Heart Hospital, Detroit Medical Center and the Baptist Health System of Texas. Has filed for a \$600 million IPO.
CCMP Capital Advisors, Canada Pension Plan Investment Board	LHP Hospital Group	Portneuf Medical Center in Idaho and Texas Health Presbyterian Hospital. Seeking Saint Mary's Hospital in Waterbury, Conn.
Cerberus Capital Management	Steward Health Care System LLC	Morton Hospital in Massachusetts, Merrimack Valley Hospital and Nashoba Valley Medical Center New Hampshire. Made a \$895 million bid for Caritas Christi Health Care in Boston and a \$1.1 billion offer for Jackson Health System of Miami
Oak Hill Capital Partners	Ascension Health Care Network	None yet. Oakhill partnered in February 2011 with Ascension Health, the largest Catholic not-for-profit health system in the U.S.
TPG Capital	IASIS Healthcare LLC	Owns 17 acute care hospitals and one behavioral health facility in seven states. Also owns a Medicaid and Medicare managed health plan in Phoenix. Recently took a 78.2% stake in Houston's St. Joseph Medical Center.
Warburg Pincus LLC	RegionalCare Hospital Network	Eliza Coffee Memorial Hospital and Shoals Hospital in Alabama, Ottumwa Regional Health Center in Iowa, Clinton Memorial Hospital in Ohio. Now seeking Landmark Health Systems Inc. and Jackson Health System of Miami, a \$1.1 billion deal.

*There are factors in the deals and, more importantly, in the health care reform act that should allay fears over patient care.*

In its 2011 industry outlook, Moody's said it expects the pace of hospital mergers and acquisitions to increase, and said the trend is "on balance, is a positive trend for the industry."<sup>9</sup> The agency said that it does not, however, expect a return to the go-go merger pace of the 1990s, which is undoubtedly a good thing: A decade ago, a poorly crafted acquisition spree at the Allegheny Health, Education and Research Foundation in Pittsburgh ended in a \$1.3 billion bankruptcy that shattered the municipal bond market for not-for-profit hospitals. Moody's also said that acquisition prices ahead will be "less lofty" than those of the earlier era.

But the agency also clearly spelled out the challenges posed by the entrance of for-profit operators into the M&A scene:

"The expansion of for profit operators and investors into markets previously dominated by not-for-profits will likely increase competitive pressures in the not-for-profit hospital industry. This will, in turn, be a force for further consolidation among all types of hospitals seeking larger economies of scale and better capital access. For investors holding debt of acquired hospitals, this may result in an increase in the credit quality of their bonds or even an exit strategy at full par. Many individual operators could become further stressed, creating an even greater need for sound management and capital strategies to compete in markets favoring larger hospital systems and chains."

## What's driving the deals?

As the Moody's assessment indicates, there is opportunity in all this chaos. The opportunity to grow earnings as health care reform reduces uncompensated care and the opportunity to create large, stable health companies like the Oak Hill Capital Partners-Ascension Health Care Network partnership. There are signs of that already in the results of the equity-backed companies: Vanguard Health's loss for the six months ended December 31 shrank to \$2 million from \$17.5 million for the like year-earlier period on a 13 percent jump in revenue. And whatever their current financial shortcomings, not-for-profit hospitals are often still the center of care in their communities, with little competition from standalone medical facilities.

There is also an opportunity to earn a profit for investors. In March 2011, the initial public offering of HCA Healthcare raised \$3.8 billion, the largest private equity-backed IPO in the U.S.<sup>10</sup> The deal capped a five-year turnaround of what is America's largest hospital operator

after a 2006 buyout by Kohlberg Kravis Roberts, Bain Capital, Merrill Lynch and members of the Frist family, who had founded the company in 1968. It also followed, by about a year, a \$1.75 billion dividend payment to Bain and KKR.

That kind of success has bred admirers in other places: In April Vanguard Health filed plans for a \$600 million IPO.

*RegionalCare Hospital Partners was founded by Martin Rash, John Rutledge and Samuel Moody, all former partners at Province Healthcare.*

## The outlook for patient care

It is precisely those kind of numbers that have raised concerns among patient advocates and others. “When private equity firms begin to show interest in the nonprofit hospital sector—when Gordon Gekko sees a profit potential in a sector that has long cried the financial blues—you know the game has changed,” worried an analyst at Duke University’s Center for Strategic Philanthropy & Civil Society last year. “It may be good for the economics of nonprofit hospitals, but it may not be quite so good for the concept of community-oriented nonprofit hospitals.<sup>11</sup>”

While many of the private equity firms have not been major investors in health care in the past, they are hardly going into these new investments blind: Warburg Pincus’ partner company, for example, is headed by three long-time health care executives. RegionalCare Hospital Partners was founded by Martin Rash, John Rutledge and Samuel Moody, all former partners at Province Healthcare. That company was sold to LifePoint Hospitals in 2005 for \$1.7 billion in cash, stock and assumed debt.<sup>12</sup>

What’s more, there are factors in the deals and, more importantly, in the health care reform act that should allay fears over patient care and employment. Some of the deals come with built-in guarantees that the equity investors will uphold their hospitals’ charity care missions and economic commitment to their communities. Cerberus pledged, as part of the Caritas deal, that there would be no layoffs among Caritas’ 12,000 employees and that it would not sell the hospitals or take them public for at least three years. When Vanguard invested in the Detroit Medical Center, it made a 10-year commitment to maintain the hospital’s charity-care policy and keep all its facilities open<sup>13</sup>.

Then there are commitments beyond the parties to the acquisitions. The PPACA contains provisions that oblige all hospitals—private equity-owned or not—to evaluate the needs of the communities they serve every three years and lay out a plan for meeting them. The health

reform act also ends one of the more egregious aspects of charity care now, which is that charity patients are often charged more than insured patients for the same procedure. There are guarantees for patient safety as well. Hospitals will be compensated for safe, effective treatments, not just procedures, and the act's mandate for electronic health records is designed to insure that hospitals close the information gaps that cost America \$19.5 billion in medical errors in 2008--and cost 2,500 patients their lives<sup>14</sup>.

Then, too, are the aptly named ACOs, which will hold health care systems accountable for the quality of care they deliver to Medicare recipients, and pay them accordingly. Accountable Care Organizations will compel all those who work on the care of a patient to coordinate their care, share information and limit unnecessary tests.

## Conclusion

Despite belt-tightening, many of America's not-for-profit hospitals are in critical condition. Some have resorted to bankruptcy to ease their debt burden and more than a few have closed.

Their weak financial state leaves them ill-prepared to deal with the challenges that health care reform will bring, or to profit from the opportunities it offers. If they are to survive and thrive, they need strong financial partners.

There is, in some quarters, apprehension over the interest of private equity funds in not-for-profit hospitals, and fear that the management style that they honed on Wall Street may be ill-suited for their new role as providers of charity care. But the terms laid down by Washington for health care reform make it clear that these new partners will be rewarded only if the changes they bring improved patient care.

Private equity investments hold promise for not-for-profit hospitals and the patients they serve. Promise in the form of new financial resources, which should make it possible for hospitals to improve their infrastructure, from their physical plants to medical equipment and information technology. Promise, too, in experienced management, who can help the acquired hospitals expand their alliances effectively and efficiently. Promise that their patient care will meet the standards of a new era.

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### NOTES

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