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Cain Brothers House Calls

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Health systems, private equity, and the government: It's complicated

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This is a companion article to an episode of "House Calls," a podcast from Cain Brothers. Listen to the audio version of the episode on Key.com, Apple Podcasts, Spotify, or your other favorite podcast app.

Sometimes a title says it all. The highly respected Kaiser Health News (KHN) launched an investigative series in June 2022 exploring private equity's expanding presence in the healthcare marketplace. KHN titled the series "Patients for Profit: How Private Equity Hijacked Healthcare." KHN is hardly alone. Numerous academic institutions and media outlets have published in-depth studies on the dangers of PE investments in healthcare.

The already negative orientation of academic and media coverage has amplified this year as Steward Health Care, the nation's largest privately owned for-profit health system, hurtled toward bankruptcy. Steward officially filed for bankruptcy on May 6, 2024.

As the Steward saga unfolds, *Axios* reports that Congress is increasing its oversight of private equity's influence in healthcare. It's undertaking multiple investigations. Amid the turmoil, there's a rush to identify villains and reach simple conclusions. Typical of this mindset are comments made last January by U.S. Rep. Stephen Lynch of Massachusetts:

> *I think the underlying message is that the for-profit model does not work. (Steward) is a for-profit health care network, and I firmly believe that it's very difficult to pursue two missions: to generate profits and still provide high-quality health care.*

This type of reductionist conclusion misses the macro reality that the healthcare marketplace is reorganizing to deliver value-based care services in a more decentralized manner (e.g., in clinics, homes, and through virtual modalities). This transition is exceptionally difficult for health systems (not-for-profit as well as for-profit) with high-cost, centralized platforms for delivering care services.

These health systems need help developing the products and services necessary to sustain market relevance. PE is a potential source of capital, expertise, and operating discipline for advancing health systems' market reach.

Not all PE is created the same, yet all PE firms are focused on generating a return on investment for their limited partners. Many PE-funded investments do efficiently exploit some of the perverse economic incentives in healthcare, creating short-term gains without "improving" the overall cost and quality of care. These are the types of investments that are drawing the scorn of the media, academic studies, and public officials. Other PE investments, however, do just the opposite. They fund innovative, value-creating enterprises.

Our purpose in this commentary is not to be apologists for PE investments in healthcare. Rather, it is to sift through the ubiquity of PE investments and provide guidance for health systems seeking constructive value-creating partnerships with PE firms. Given the fast-paced transformation occurring within the provider sector, health systems have never needed constructive assistance more.

A system stuck in transformation

Most not-for-profit- health systems in the U.S. are struggling on multiple fronts. Patients are older, sicker, and more costly to treat. Labor challenges continue to intensify. The need for new technology investments seems insatiable.

Already marginally profitable businesses, hospitals are faced with compounding operational and financial challenges, including the increasing percentage of lower-paying Medicare- and Medicaid-insured patients. A growing number of facilities, particularly in low-income rural and urban communities, are closing. These closures often compromise equitable access to health care services.

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While necessary to lower costs and improve health outcomes, the transition to value-based care is exceptionally difficult for most health systems. Their high-cost, centralized delivery platforms resist easy change. Moving to risk-based contracting requires massive investments in new care delivery channels (ambulatory care, urgent care clinic, home health, virtual care, and others), consumerism, and omni-channel digital platforms.

In addition, health system boards (especially at not-for-profit systems) are often poorly equipped to support and guide paradigm-shifting investments. Moreover, executive leaders typically lack the business experience and networks to execute such complex strategies effectively.

Enter private equity. PE offers an experienced source of capital, expertise, and operating discipline. Health systems can lean on those capabilities to develop viable new products and service lines that secure their current market position and extend their reach into new markets.

The financial, regulatory, demographic, technological, and competitive realities today have created circumstances under which health systems must adapt or die. This requires implementing value-based care delivery models. This challenge isn't disappearing. Enlightened health systems are rising up to meet it.

Creative and conflicting tensions with private equity

PE plays an increasingly large role in the American economy and in U.S. healthcare specifically. In 2021, private equity invested a record $1 trillion-plus in the U.S. economy. In 2023, that number declined to a still-substantial $645.3 billion. Experts estimate that PE has $955.7 billion of available investment capital today, giving it an enormous capacity for acquisitions.

Much PE capital (around $1 trillion over the past 15 years) has gone to U.S. healthcare companies, including hospitals, nursing homes, physician/provider groups, specialty provider groups, digital tech companies, imaging companies, life sciences companies, medtech companies, and others. It's estimated that PE owns 386 U.S. hospitals. These PE-owned hospitals represent 9% of all U.S. hospitals and 30% of for-profit hospitals.

Contrary to popular perception, PE investment focuses on longer-term value rather than short-term returns. It simply must. To "exit" their investments, PE firms must convince new buyers that they have created sufficient value to justify the purchase price.

While critics of PE cite aggressive strategies such as layoffs, asset sales, and debt allocation as standard business practices, investment growth is the overwhelming priority for driving returns. As with any distressed business, hard-edged decisions around asset reallocation and restructuring can be necessary to right the ship and position an organization for growth and market success.

As cited in numerous research and media reports, some of that PE investment has had a negative impact on patient outcomes, access, and quality of care. Many PE investments, however, fund innovative, value-creating enterprises that bring important services to underserved markets. Given their challenges, health systems are understandably drawn to that potential and the trillion dollars PE has at its disposal.

The rise and fall of Steward Health Care

Contrary to media reports, PE investments actually played a constructive and essential role in Steward Health Care's creation, repositioning, and operations. Examining Steward's history is an effective lens into the ways in which PE can create value within the healthcare marketplace.

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The Steward story begins in 2010 when Caritas Christi Health Care, New England's second-largest health system, faced certain bankruptcy. Caritas Christi was a not-for-profit, Catholic-owned health system with facilities serving low- to moderate-income communities in Massachusetts, southern New Hampshire, and Rhode Island. The health system had 14,000 employees.

The disruption of care delivery, potential job losses, and pension dilution made Caritas Christi's looming failure all the more alarming. In response, the Archdiocese of Boston sought but could not find a not-for-profit health system as an acquisition partner. Its best alternative was to sell Caritas Christi's assets to PE firm Cerberus.

After the sale, Cerberus converted the system to for-profit status and rebranded it as Steward Health Care. The sale provisions included rigorous oversight of Steward's operations by the Massachusetts Department of Health and the Archdiocese of Boston. With new ownership and substantial new capital investment, Steward's leadership team set out to become a fully integrated accountable care organization (ACO) with upgraded facilities, improved care quality, and new technologies.

The decision to sell to the private equity firm was hailed for its potential to avert financial disaster and give birth to a better health system. As Archbishop Cardinal O'Malley said:

> *As a result of this transaction, Caritas will have access to much-needed capital for its infrastructure and programs, and also its pension obligations, while continuing to provide high-quality health care, especially for the poor, in accord with Catholic teaching.*

Steward's novel business model and bold movement into value-based care delivery paid dividends. By 2015, Steward was profitable and had become the state's leading provider of community-based health care. In 2016, Steward sold its hospitals to real estate investment trust (REIT) Medical Properties Trust for $1.2 billion. It used that capital to pay off debt, repay a portion of Cerberus' investment, and fund additional capital improvements.

This sale-leaseback arrangement was unusual in healthcare at the time but has long been common in other industries such as hotels and airlines. The MPT transaction not only infused new capital into Steward but enabled the system to improve its operating profile without the significant financial risks associated with facility ownership.

For most health systems, hospital ownership is sacrosanct. Indeed, because of the unique capital formation requirements of not-for-profit systems, new hospital investment is one of the easiest ways for health systems to deploy capital. However, this strategy ties the majority of the health system's capital into high-cost facilities whose value depreciates over time. In essence, Steward negotiated a premium price for selling its hospital assets while reducing its overall financial risk.

Steward's wins in New England ultimately became a source of its later failure. Encouraged by the success of its business model, MPT subsequently served as Steward's capital partner in an aggressive expansion strategy. Steward acquired eight additional hospitals in 10 states and entered a leaseback arrangement with MPT to operate them. This made Steward the largest private, for-profit hospital operator in the U.S.

It is important to note that MPT and REIT financing, not PE investment, funded Steward's expansive growth. In 2020, Steward physicians, led by CEO Ralph de la Torre, bought out Cerberus and acquired 90% of the company, with MPT owning the remaining 10%. So, what went wrong? In a nutshell, Steward's leadership team simply bit off more than it could chew. While Steward's operating model worked well in New England, movement into so many new and compromised markets in such a short time created enormous integration issues. Steward's lean management team lacked the depth and market knowledge necessary to negotiate favorable contracts, earn physicians' trust, and replicate their novel value-based operating models with success.

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Steward's timing was also bad. The COVID-19 pandemic wreaked havoc on operations, even as the system remained operational to serve its local communities' needs. Post-pandemic, higher labor and supply costs, in combination with scheduled rent increases to its landlord, MPT, pushed Steward toward insolvency.

In essence, Steward went broke the old-fashioned way. It spent too much money expanding too quickly on too many assets without the wherewithal to operate them as an integrated whole. As Thomas Edison wisely observed, "Vision without execution is a hallucination." With poor execution, Steward's vision of a nationwide platform of efficient community-based care networks became a nightmare. PE had nothing to do with it.

Conclusion: Eyes open. Feet forward.

There can be an amoral quality to PE investing. PE firms are heat-seeking missiles for investing in growth opportunities and generating returns. Their expansive use of leverage and intense focus on revenue generation are proven strategies across industries for promoting operating efficiencies and increasing profit. PE investments succeed more often than they don't. This is why the levels of PE investment are increasing.

In contrast to other industries, healthcare is replete with complexity, perverse economic incentives, rampant inefficiency, and ineffective regulation. The sector invites investments that optimize or exploit inefficiencies without solving larger issues. And PE is far from alone in this behavior.

What upsets researchers, policy wonks, public officials, and community representatives is when PE firms aggressively pursue investments that highlight a system's current dysfunction. Yet these same constituents take no ownership for the complexity they have created. With its vast capital and deep investment expertise, PE may be primarily guilty of being more skillful and aggressive than other investors. The challenge for health systems is to engage with PE firms that can create value in partnership with them.

The larger problem U.S. healthcare confronts is the nature of the system itself. In a rational healthcare marketplace, resources would already have shifted to higher-value, higher-returning investments. Most notably, this includes investments in community-based health networks and facilities that promote better outcomes and more robust population health.

The transformation to democratized and decentralized distribution of whole-person health services is well underway. It's hugely disruptive to current healthcare practice patterns. In part, this is why health system business models that emphasize transactional, revenue-optimizing volume are under such enormous market pressure. They deplete, rather than create, value.

As an investment vehicle, PE is well-suited to help health systems transition to more efficient and effective operating platforms. Indeed, this is what Cerberus helped Steward achieve. What PE did for Steward during its more successful era, it can also do for other health systems focused on value-creating delivery models. What PE cannot do for health systems is protect them from making bad strategic, investment, and resource allocation decisions.

Paraphrasing Shakespeare, the problem with health systems lies not within PE but within themselves. PE is a funding and partnership mechanism with unique and often helpful attributes. During a time of industry disruption, it makes no sense to throw the PE baby out with the bathwater. It does make sense to engage with the right PE investors in pursuit of value-creating enterprises. Knowing how and when to do this effectively makes all the difference.

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