

# Vultures in the E.R.

Private-equity firms target the U.S. health-care industry.

BY NICOLE ASCHOFF

**PUBLIC ANGER OVER INCREASING ECONOMIC POLARIZATION AND** frustration with the seemingly unassailable power of big finance coalesced for a brief moment last summer in the public shaming of Bain Capital, the private-equity firm formerly run by Mitt Romney. Popular journalists like *Rolling Stone's* Matt Taibbi turned their attention to the activities of powerful, secretive private equity firms, connecting the dots between private-equity investment and job loss, and people got mad. But, as with the leveraged-buyout kings of the 1980s, after the election furor subsided, Bain and its private-equity brethren dropped back under the radar, returning to business as usual.

However, the nature of “business as usual” for private equity warrants another look. Private-equity (PE) firms like Bain, Cerberus, Blackstone, Warburg Pincus, and Kohlberg, Kravis and Roberts (KKR) operate in nearly every sector of the economy, including manufacturing, business and financial services, food, entertainment, and health care. Cutthroat tactics, job loss, and bankruptcy are common themes in the PE world (see John Miller, “Private Equity Moguls and the Common Good,” *Dollars & Sense*, July/August 2012).

Health care is a particularly popular sector for PE firms. After a decline following the 2008 financial crisis, PE investment in health care has rebounded, both in the United States and globally. In particular, medical technology, pharmaceuticals, and medical services (like hospitals and nursing homes) are seeing sharp increases in PE investment. According to a recent report by Bain, the value of global private-equity deals in health care was over \$30 billion in 2011, double the investment of 2010.

Growing PE interest in low-profit, or no-profit, sectors like hospitals may come as a surprise to many who assume that private investors prefer to channel their money toward industries with rapid growth or high profit potential, like medical technology and pharmaceuticals. But private-equity firms are not like most investors. Unlike venture capitalists, who bet their own money on the success of a company, in most cases private-equity firms put very little of their own capital into their investments, and instead arrange for outside investors (like pension funds) and the firm being taken over to fund the investment. The PE firms make their money from fees and dividends, which are often debt-financed by the acquired firm. This unique feature of private-equity firms means that any company with steady cash flow (or even just a substantial potential cash flow) is a possible target for acquisition. >>



Harper Hospital and Hutzel Women's Hospital (shown here in 2009) are part of Detroit Medical Center, which was bought by Vanguard Health in 2010. At the time, Vanguard was owned by the PE firm The Blackstone Group, L.P. (Parkerdr, Wikimedia Commons, Creative Commons Attribution 2.0 license.)

A black vulture\* (*Aegypius monachus*), in flight over the Sierra de Guadarrama, Spain, Sept. 19, 2005. (Clément Godbarge, Wikimedia Commons, Creative Commons Attribution 3.0 license.)

\*Comparison with PE firms not intended to disparage vultures.

The growing appetite for hospital takeovers by PE firms has its roots in the ongoing struggle for survival experienced by many hospitals. Hospitals—particularly small, community hospitals and those serving poor populations—are under intense pressure due to declining Medicare/Medicaid reimbursement rates, new government demands for technological upgrades, increasing numbers of under- and uninsured patients, and restricted access to credit markets. According to the American Hospital Association (AHA), roughly 30% of non-profit hospitals are operating at a loss. Many more hospitals find themselves breaking even each year, but unable to borrow and make investments to keep up with increasing costs and regulation.

The precarious financial situation of many community hospitals has led to a wave of mergers and acquisitions in recent years by for-profit hospital corporations and larger non-profit systems. Community hospitals believe that being absorbed by a larger hospital or hospital chain will result in improved access to capital to make necessary upgrades and maintain their patient base. Meanwhile, big, for-profit, and non-profit hospitals view the acquisition of smaller, community hospitals as an easy way to increase market share and improve economies of scale.

This consolidation trend is similar to the one that occurred in the hospital sector in the 1990s,

but with one significant difference—the increasing role of PE investors. PE investors are betting that the growing needs of the baby-boomer generation, in combination with the Affordable Care Act, which will dramatically expand health-insurance coverage (an estimated 15-20 million new insured by 2014, and an additional 15 million by 2016), will create new profit opportunities. For example, in 2006, KKR, Bain, and Merrill Lynch acquired the mammoth Hospital Corporation of America (HCA), a for-profit hospital chain that owns hundreds of hospitals in the United States and England, for \$31.6 billion. PE firms are also snapping up non-profit, community hospitals. In December 2010, Vanguard Health (owned at the time by Blackstone), bought the Detroit Medical Center for \$1.3 billion. In the same year, Cerberus Capital Management paid \$830 million to acquire the Caritas Christi chain of hospitals from the Archdiocese of Boston, folding the hospitals into a new, for-profit entity called Steward Health Care System. Although the AHA estimates that less than 20% of community hospitals are investor-owned, the number is growing rapidly. Josh Kosman, an expert on PE investment, estimates that half of the biggest for-profit hospital chains are now owned by private-equity firms.

One of the strategies followed by PE-backed, for-profit hospital chains like Vanguard and Steward is to gain control over urban market share by aggressively acquiring hospital groups. This strategy is a departure

**Carney Hospital in  
Dorchester, Mass. is  
part of the Steward  
Health Care System,  
which is owned by the  
PE firm Cerberus  
Capital Management.  
(Public domain).**

**Vultures (species  
unknown) in Kruger  
National Park, South  
Africa, May 20, 2012.  
(Harvey Barrison,  
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from earlier, more scattered, and somewhat opportunistic, acquisition patterns by for-profit hospital chains like HCA and Essent. Vanguard's purchase of Detroit Medical Center gave it control over 13.4% of Detroit's total market, while its 2010 purchase of Westlake Hospital and West Suburban Medical Center in Illinois gave it 47% of acute care inpatient beds in the immediate health planning area. Steward's recent acquisitions, including its purchase of the Caritas chain, give it control over a quarter of eastern Massachusetts acute care beds.

### **What's the Difference?**

All hospitals are facing similar market conditions and are concerned with minimizing costs and increasing revenues. So what is the difference between not-for-profit systems like Partners, for-profit hospital chains such as Tenet and LifePoint, and PE-owned hospital chains like Steward? A recent report issued by the Congressional Budget Office suggests that there is little difference in the behavior of non-profit and for-profit hospitals. The report found that not-for-profit hospitals on average provide slightly higher levels of uncompensated care than for-profit hospitals, while for-profit hospitals, on average, serve poorer populations with higher rates of people living with little or no health insurance.

However, Jill Horwitz, a professor at the University of Michigan, argues that nonprofit hospitals and for-profit hospitals exhibit important differences in the types of care they offer. For-profit firms emphasize surgical and acute care services, and cardiac and diagnostic services, while non-profit hospitals often provide less lucrative care such as mental health services, drug-and-alcohol treatment programs, and trauma-and-burn centers. When non-profit hospitals are converted into for-profits, they often discontinue or decrease these crucial, but less-profitable, services.

PE-backed hospital firms are particularly likely to jettison less-profitable services given their shorter investment timelines. Like most PE investments, PE firms' hospital acquisitions tend to last a short period (around five years). Then, the PE firm either takes the acquired firm public (offers stock for sale to the general public) or re-sells to other PE firms. For example, HCA was owned by two PE firms (KKR and Bain) for five years before a March 2011 initial public offering of stock (IPO), while Vanguard was owned by Morgan Stanley and Blackstone before going public in June 2011. The PE owners' goal during this period of time is to quickly increase profits and cash flow,

enabling the PE firm to collect its fees and dividends, often by accessing credit and bond markets.

This investment timeline pushes PE firms to look for simple, and relatively fast, ways to increase revenues, such as eliminating less-profitable services. For example, in 2004, Vanguard's Weiss Hospital in Chicago failed a spot inspection for maternity-ward security. Staff failed to stop undercover inspectors from removing a baby (actually, for the purpose of the inspection, just an infant doll) from the ward without authorization. Rather than resolve the issue through increased staffing and a reexamination of hospital policy, Vanguard simply closed the maternity wing in 2007, eliminating a vital service for the surrounding community.

At the Vanguard-acquired Phoenix Memorial Hospital, located in a predominately urban, poor area of Phoenix, the company announced the closure of the emergency room despite earlier promises to the contrary. After a public outcry, Vanguard

## **PE investors are betting on new profit opportunities from the growing needs of the baby-boomer generation and from the Affordable Care Act, which will dramatically expand health-insurance coverage.**

shelved the plan, but just a few years later closed the entire hospital and leased out the space. In the meantime, Vanguard invested heavily in surgical and ambulatory services at a nearby hospital in Phoenix's wealthier western suburbs.

In addition to reducing less-profitable services, PE-owned hospitals look for other ways to increase profits. These include centralizing and improving billing, records management, and financial services, and reducing staff, particularly registered nurses. In late 2011, nurses organized by the Massachusetts Nurses Association (MNA) gathered at Cerberus headquarters in New York to protest cuts of registered nurses on duty at Steward's Morton Hospital in southeastern Massachusetts. Since Steward's creation in 2010, the MNA and Steward have been at loggerheads. The MNA argues that Steward has cut the level of registered nurses to dangerously low levels at a number of its hospitals, including psychiatric units



like the one at Carney Hospital in Boston, and has cut back on basics for patients. Nurses at Holy Family Hospital in northeastern Massachusetts complained that they were not allowed to give patients even a cup of coffee, while nurses at Norwood Hospital (in Norwood, Mass., south of Boston) brought loaves of bread to their floor to protest decreased food for patients. Nurses at Merrimack Valley Hospital, also in northeastern Massachusetts, claimed that administrators were turning down the temperature of electric blankets for chemotherapy patients to save pennies. The MNA and Steward are also fighting an ongoing battle over the MNA's pension plan. The MNA argues that Steward has refused to honor the pension agreement the union made with Caritas Christi, the for-

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mer owner of the Steward chain, prior to the PE firm's 2010 acquisition.

PE-owned hospitals also engage in less-visible strategies to boost profits such as increasing lucrative surgical procedures. In 2005, the former chief compliance officer at the PE-owned Iasis hospital chain filed a complaint under the False Claims Act, alleging that doctors at St. Luke's Medical Center in Phoenix were installing a specific kind of heart implant—the intra-aortic pump—at ten times the normal rate. The alleged motive? Iasis could bill patients an additional \$1000. In a 2012 exposé, the *New York Times* reported that an internal HCA memo showed that the company performed 1,200 cardiac procedures on patients without significant heart disease. The whistleblower, a registered nurse at a Florida HCA hospital, was fired for reporting the abuse.

**The Biggest Difference: The Debt Trap**

While service and staffing cuts, deteriorating patient care, and potentially unethical medical

practices are easy to find at PE-owned hospitals and deserve urgent attention, they are not uniformly present at all PE-owned hospitals, and are also present at many non-PE-owned hospitals, both for-profit and non-profit. There is, however, another much bigger problem particular to PE hospital ownership.

PE firms are often portrayed as “turnaround” specialists and are viewed by many, including the hospitals themselves, as white knights bringing desperately needed investment and credit access. The problem with this view is that PE firms do not actually earn their money by turning around companies and making them successful. A PE firm's return on investment has little relation to whether the acquired hospital succeeds through improved patient care or increased cash flow. Instead, PE firms recoup their investment through fees (management fees, transaction fees, selling fees, etc.) from both the acquired firm and outside institutional investors. In fact, unlike other kinds of investment firms, PE firms generally put only a small percentage of the total equity down themselves, instead getting outside investors to cover the bulk of the initial equity investment. So even if the PE firm's investment fails to yield the imagined profits, the PE firm still earns a profit, or loses little or no money, because the risk is shouldered by outside investors, and in many cases, the acquired firm itself.

The primary source of risk for hospitals being acquired by PE firms is the debt load that comes with PE ownership. PE firms use the acquired hospital as a vehicle to earn profits by forcing it to sell bonds or shares, or take on bank debt, to pay the PE firm fees and dividends. For example, in January 2010, Vanguard took on \$1.76 billion in debt, of which \$300 million went to pay dividends to Blackstone. In June 2010, the hospital chain issued an additional \$250 million in bonds and, in January 2011, the company recapitalized again. It paid a grand total of \$775 million in debt-funded dividends to its PE sponsors between January 2010 and summer 2011.

When PE-backed hospital chains like Vanguard and HCA go public, they (and their PE sponsor) are able to make huge profits from their initial public offerings (IPOs). HCA raked in a record \$3.8 billion at its 2011 IPO, but the money from the IPO went directly to chip away at the huge debt HCA incurred under KKR and Bain ownership. In the spring of the previous year, HCA's PE owners borrowed \$2.5 billion to pay themselves a

dividend, and then followed up in December with a junk-bond sale to pay themselves another nearly \$2 billion dividend. As a result, under PE ownership, hospital companies like Vanguard and HCA, and all the community hospitals they have acquired along the way, become buried under a mountain of debt that stays with them long after their PE sponsor has moved on to other investments.

High levels of debt make hospitals vulnerable to changes in the industry as well as broader economic shifts. When credit markets are loose and the economy is growing, hospitals can manage their debt by issuing bonds to cover interest payments or by tapping revolving lines of credit from banks, enabling a steady inflow of funds. But these safety valves quickly disappear during broader economic downturns. A contraction in credit markets can make it difficult or impossible for hospitals to service debt by accessing new sources of liquidity. At the same time, because hospitals are saddled with so much debt, profits are channeled toward servicing the debt rather than building up cash reserves or making long-term investments in patient care or technology. This weakens the hospitals' ability to adjust to industry or economic shifts and makes them more likely to end up in bankruptcy.

The pitfalls associated with PE ownership have, in some cases, led to pushback against PE hospital acquisitions. For example, when Steward attempted to acquire Florida's non-profit Jackson Health System in 2011, it was met with public outcry from Miami residents and local politicians and was forced to back out of the deal. Unions have also been vocal opponents. In 2010, Council 31 of AFSCME in Chicago fought hard against the sale of Westlake Hospital and West Suburban Medical Center to Vanguard Health Systems, but ultimately failed to prevent the sale. Some states have attached conditions to deals involving the transformation of non-profit hospitals to for-profit, PE-owned entities. Michigan's attorney general forced Vanguard to agree to continue existing operations and services at the Detroit Medical Center for ten years after the 2010 purchase date, including commitments to charity care and research. However, the Michigan deal is exceptional, and most PE-hospital acquisitions come with few restrictions on the sale or closure of facilities.

The future of PE investment in hospitals depends on a number of factors, including the cost and availability of credit, health care legislation, and the public response to PE ownership. PE interest in



the hospital sector hinges on cheap credit. If credit markets contract, and PE firms find it harder to arrange financing for their investment deals, they may lose interest in health care and instead restrict their investments to more profitable ventures. However, growing demand for health care, in the context of increased hospital obligations and restrictions as a result of the Affordable Care Act, may make community hospitals more vulnerable, and actually increase their attractiveness as takeover targets. Ultimately, the most promising avenue for restricting, or ideally, preventing PE takeovers of hospitals is to publicly scrutinize their behavior and demand alternative forms of financial support for the hospitals, doctors, and nurses struggling to provide affordable, high-quality care. **D&S**

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**NICOLE M. ASCHOFF** is a post-doctoral fellow in the sociology department at Boston University.

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**SOURCES:** Tim van Biesen and Karen Murphy, "Global Healthcare Private Equity Report 2012," Bain & Company, 2012; Advisen, "Private equity and hospitals: providence or problem," OneBeacon Professional Insurance, 2011; Lisa Goldstein, "New forces driving rise in not-for-profit hospital consolidation," Moody's Investor Service, 2012; Josh Kosman, *The Buyout of America: How Private Equity Will Cause the Next Great Credit Crisis* (New York: Portfolio, 2009); Congressional Budget Office, "Non-profit hospitals and the provision of community benefits," Dec., 2006; Jill Horwitz, "Making Profits And Providing Care: Comparing Nonprofit, For-Profit, And Government Hospitals," *Health Affairs*, 24 (3), May 2005; Reed Abelson and Julie Creswell, "Hospital Chain Inquiry Cited Unnecessary Cardiac Work," *New York Times*, Aug. 6, 2012.



**Morton Hospital in Taunton, Mass., is part of the Cerberus-owned Steward chain. (Public domain.)**

**A white-headed vulture (*Trigonoceps occipitalis*) flying in Kruger National Park, South Africa, Oct. 24, 2011. (hyper7pro, Wikimedia Commons, Creative Commons Attribution 2.0 license.)**