# Cerberus's health care play

## The owner of the for-profit Steward Health Care is taking on Boston's big teaching hospitals

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CHRIS HOPEY, THE president of Merrimack College, brought an intriguing proposal late last year to his board of trustees: Steward Health Care, the upstart, for-profit hospital chain that is challenging some of the biggest players in the Massachusetts health care industry, wanted to transfer Carney Hospital in Dorchester to the North Andover school.

Three sources familiar with the hush-hush discussions say Hopey told the board members that Steward was looking to unload Carney and Laboure College, a nursing school attached to the hospital that is also owned by Steward. Merrimack was seen as a potential match for the hospital and the nursing school because the college is interested in getting into the health care education field. Merrimack is also Catholic, making it a good fit for a hospital that formerly was part of the Boston Archdiocese's Caritas Christi hospital chain.

But Steward's overture to Merrimack raised a lot of questions. Why did Steward want to unload Carney, a hospital it acquired only a year before? Was Steward's focus on community-centric health care unraveling? And could Steward legally transfer Carney to someone else? When Steward purchased the


Illustration by Yuta Onoda.

Caritas chain of six Massachusetts hospitals in October 2010, the Boston-based company agreed not to close, sell, or transfer a majority ownership interest in any of the hospitals for at least three years. Would a transfer to a third party be a violation of the agreement?

Hopey and school officials aren't talking. Steward spokesman Christopher Murphy is also tight-lipped. He initially insisted the hospital chain never offered "to give away" any of its hospitals, but refused to discuss whether Steward entered into discussions with Merrimack about the future of Carney. Just before *CommonWealth* went to press, however, Murphy said it was Merrimack that approached Steward to discuss an academic relationship with Laboure. He declined to comment further, but it would appear those initial talks led to a broader discussion about transferring both Carney and Laboure to Merrimack.

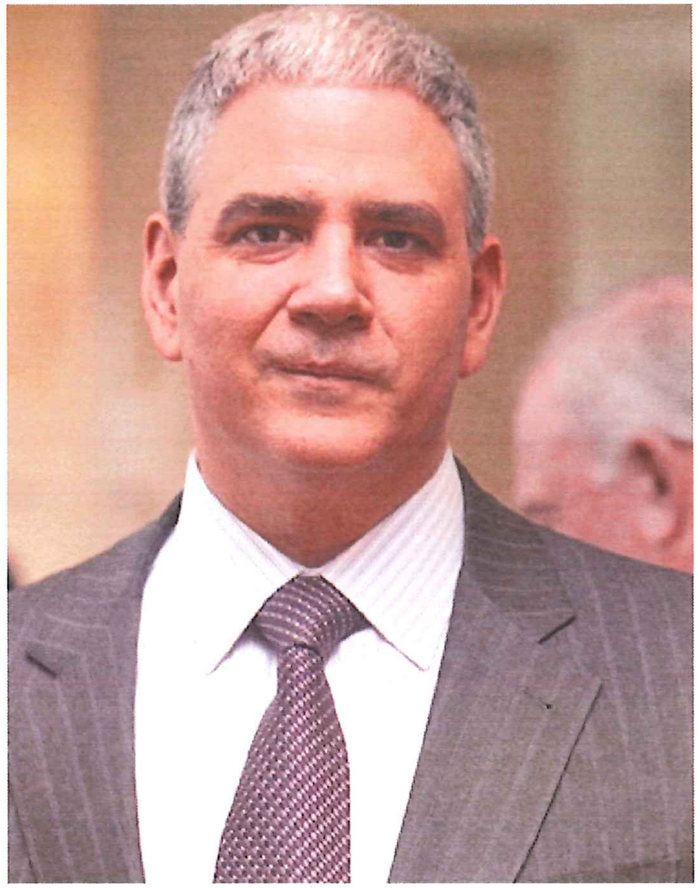
Whatever the genesis of the idea, Merrimack's board ultimately decided not to pursue a Carney -Laboure deal, probably for the same reasons Steward was interested in pursuing it. Located in one of Boston's poorest neighborhoods, Carney reportedly has been losing money for years and was on the verge of closing when Steward bought it. Steward officials say 70 percent of the residents in the surrounding neighborhoods bypass Carney and go elsewhere for their care. Even within Steward, there is no consensus about what to do with Carney, which became evident in April when Bill Walczak, the popular neighborhood activist hired by Steward to run the hospital, was fired after just 14 months on the job. Neither Steward nor Walczak will say what prompted his departure, but it's a safe bet there was a disagreement about the future of the hospital.

The discussions with Merrimack are a sign that Steward's bold plan to turn a string of money-losing hospitals into a profitable health care juggernaut may be facing some glitches. Owned by Cerberus Capital Management, a secretive New York private equity firm, Steward has been shaking things up in one of the state's biggest and most important industries. The company's 10 hospitals may not be big names and their finances may be shaky, but Ralph de la Torre, the CEO of Steward, has fashioned them into a health care network that he says can provide high quality care at much lower cost than the big Boston teaching hospitals. De la Torre, who used to work at one of those teaching hospitals as the chief of cardiac surgery at Beth Israel Deaconess, says Steward, if it can win over residents and businesses near the hospitals, can not only turn a profit for Cerberus but lower health care costs overall.

Steward officials say they will turn a profit this year and are poised to take their health care experiment beyond the state's borders and onto a national stage. De la Torre declined to talk to *CommonWealth* (his spokesman says he is booked for months), but there is no shortage of people in the state's health care community who will talk about him, as long as their comments are kept off the record. Many expect him and Cerberus to crash and burn in Massachusetts, but no one is saying that publicly. Indeed, de la Torre is riding high right now. *Boston* magazine, in its April "power issue," put de la Torre on the cover, ranking him 12th among the 50 most powerful people in Boston, right behind Gary Gottlieb, his counterpart at the much larger Partners HealthCare, the corporate parent of Massachusetts General Hospital and Brigham and Women's Hospital.

Tom Glynn, a former Partners HealthCare executive who is now a lecturer in public policy at Harvard's Kennedy School of Government, says de la Torre deserves all the attention. "If you asked me which health care leader over the last five years has had the greatest impact, I'd say Ralph de la Torre. It's been a great first act," he says. "The question is: What's his second act? He's assembled this thing, but how's he going to make it profitable?"

## STEWARD'S STRATEGY


Ralph de la Torre was chief of cardiac surgery at one of Boston's teaching hospitals before becoming Steward's CEO. Photo courtesy *The Patriot Ledger*.

Steward may be a collection of somewhat tired community hospitals, but employees talk about the company's business strategy as if it's a killer app. De la Torre wants to put the brakes on the flow of patient traffic heading into Boston's academic medical centers, such as Massachusetts General, Brigham and Women's, and Beth Israel Deaconess, and redirect it to Steward's hospitals. Steward says 50 to 60 percent of routine inpatient care takes place at teaching and specialty hospitals, even though state data indicate the cost of that care is significantly higher than what other hospitals charge and the patient outcomes, on average, are not dramatically different. At a time when private insurers and state and federal regulators are trying to rein in the cost of health care, Steward thinks its cost advantage over teaching hospitals gives it a significant competitive edge. "Our model is very disruptive to the academic medical centers," says David Morales, Steward's vice president of public policy and strategic planning.

Steward currently operates 10 hospitals in eastern Massachusetts and is in the process of adding an eleventh. It is also buying a hospital in Rhode Island. Two of Steward's Massachusetts hospitals are in Boston—St. Elizabeth's in Brighton and Carney in Dorchester. The others are Nashoba Valley Medical Center in Ayer, Good Samaritan in Brockton, St. Anne's in Fall River, Merrimack Valley in Haverhill, Holy Family in Methuen, Morton Hospital in Taunton, Norwood Hospital, and Quincy Medical Center. New England Sinai Hospital, in Stoughton, is going through the regulatory process for converting a nonprofit hospital to a for-profit one, as is Landmark Medical Center in Woonsocket, Rhode Island.

Individually, the hospitals are all major employers in their local communities, but tend to be minor players on the Massachusetts health care scene. Together, however, they represent an imposing force, a $1.8 billion company that is the third largest employer in Massachusetts. Steward's 17,000 workers care for 1.2 million patients annually. Approximately 40 percent of the patients are on Medicare and 15 percent are on Medicaid, the state and federal health insurance program for the poor and the disabled. A quarter of the acute care hospital beds in eastern Massachusetts are controlled by Steward.

During an interview at Steward's Boylston Street headquarters in Boston, Morales says the company's business model revolves around a series of 2011 reports done on the Massachusetts health care market by the state and the attorney general. The reports indicate prices paid for health care services vary significantly from one hospital to the next while the outcomes do not. The reports also suggest that a disproportionate number of patients flock to higher-cost teaching hospitals for their care. In an interview last year with *The Deal* magazine, de la Torre said patients seeking routine care at teaching hospitals are paying far more than they should. "It's as if you took your Ford to the Ferrari Formula 1 garage for repairs," he said.

Rich Copp, a spokesman for Partners HealthCare, says his company recognizes that care has to be provided in the appropriate setting. "When it comes to the patient, we agree that providing the right care in the right place, close to home if possible—that's the best thing for patients," he says. "Partners' community hospitals, community health centers—they're all important components of delivering the best care possible to our patients close to home."

Morales and Murphy, the Steward spokesman, say the only reason the big Boston teaching hospitals are gobbling up community hospitals in the suburbs is so more patients can be referred into Boston "to feed the beast." By contrast, they say, Steward wants to keep care (and jobs) in local communities where it can be provided more cheaply. Morales estimates community hospitals are 25 percent less expensive than teaching hospitals. "The key for us is the economics," he says. "Our hospitals, and community care in general, are lower cost."

But Steward isn't low cost across the board. The state's 2011 report on health care cost trends found wide variations in prices. The private payer severity-adjusted median price of a vaginal birth, for example, ranged from a low of $3,430 to a high of $6,185 among 46 hospitals surveyed. Steward's St. Elizabeth's in Brighton had the highest price, edging out Massachusetts General ($6,146), Brigham and Women's ($5,943), and Beth Israel Deaconess ($5,413). Other Steward hospitals included in the survey were more moderately priced. Good Samaritan in Brockton charged $4,749 and Holy Family in Methuen charged $4,392. The prices of Morton and Norwood Hospitals were $4,077 and $4,067, respectively.


Steward quietly entered talks with Merrimack College for the school to take over Carney Hospital and its nursing school, Laboure College, just one year after purchasing the facilities. Photo by J. Cappuccio.

Morales says prices for individual hospital services are less important than broader indicators that measure a hospital's total medical expenses or how much the hospital is being paid by insurers relative to its competitors. On both scores, Morales says, Steward is below the state median, and below the Boston teaching hospitals. Still, there is fairly wide pricing variation within the Steward network of hospitals, with St. Elizabeth's consistently on the high end.

Steward is trying to enhance any cost advantage it has by paring back the cost of services it provides and attempting to reduce how often those services are needed. The Steward chain is also cutting costs by merging many of the business functions at its hospitals. Instead of each hospital operating its own human resources, finance, purchasing, and information technology divisions, Steward is consolidating them all in one location.

Steward is also positioning itself to take advantage of a shift by insurers toward paying health care providers based on patient outcomes rather than the individual services they provide. More than 80 percent of Steward's patients are currently under so-called global budgets, where Steward receives a fixed amount of money per patient to provide care. Under these contracts, Steward makes more money the more efficient it is in caring for patients. Wherever possible, company officials say, they are shifting treatment to lower-cost settings, such as a doctor's office or a patient's home.

Perhaps the most visible evidence of Steward's pricing advantage is its limited network health plan, which it unveiled earlier this year and offers to small businesses through Tufts Health Plan and Fallon Community Health Plan. Subscribers are required to seek all their care at Steward hospitals, although referrals to Massachusetts General, Brigham and Women's, or MGH Pediatric are permitted if Steward doesn't provide the needed service. The referral must be approved by a Steward care coordinator.

By keeping nearly all the care within the Steward network, the hospital chain says it can offer significant savings. For example, the company says a South Attleboro firm with 17 employees will see its annual premium for HMO coverage drop from $188,000 to $134,000 on Steward's limited network plan, a savings of $54,000, or 29 percent. Similarly, an Andover company with 25 employees will see its bill drop from $191,000 to $146,500, saving $44,500, or 23 percent.

Steward officials say 100 small businesses signed up for the limited network plan in the first 100 days, but they decline to say how many subscribers the plan has. Tufts and Fallon referred all questions about the plan to Steward.

## CERBERUS'S PROFIT PURSUIT

The biggest mystery surrounding Steward is how its owner, Cerberus Capital Management, plans to make a profit. Cerberus officials have said little about their long-term plans, other than that they want Steward to be successful and they want to hold on to the company, at least for awhile. De la Torre has suggested Cerberus wants to develop and refine the Steward business model in Massachusetts and then roll it out to other states. Cerberus typically buys distressed companies at bargain-basement prices, fixes them up, and flips them, either by selling stock to the public or selling them to another buyer. Cerberus often charges its acquired companies a fee for providing management services and leverages its own investments with borrowed money.

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Cerberus investors expect a hefty rate of return on the $23 billion they have pumped into the company. Cerberus rarely disappoints, but setbacks do happen. Cerberus lost about $1 billion on its investment in Chrysler when the auto manufacturer declared bankruptcy in 2009. And the company was accused of essentially driving the California-based Mervyn's department store chain into bankruptcy by pulling hundreds of millions of dollars out of the firm and stripping it of its real estate assets. Cerberus is currently an investor in 22 companies, everything from a Burger King franchisee to a Los Angeles movie studio.

What initially drew Cerberus to Massachusetts was de la Torre. Cerberus had attempted to hire him in 2009, but he was busy trying to turn around the six Caritas Christi hospitals owned by the Boston Archdiocese. De la Torre was making some headway, but the chain's finances were a mess, so the Caritas board began exploring a sale. Caritas signed a letter of intent to sell to Vanguard Health Systems of Nashville in early November 2009, but that deal fell apart a month later, in part because Vanguard wouldn't agree to keep all of the hospitals open. Cerberus agreed to buy the chain in January 2010, but it took another 10 months before regulators gave the green light for the six nonprofit hospitals owned by the Boston Archdiocese to become the first health care acquisition of a company named for the dog that guards the gates of hell.

The health care industry is going through a massive consolidation, brought on by the weak economy, growing pressure to rein in prices, and changes in the way hospitals are compensated. Most hospitals have decided bigger is better as they cut costs and try to coordinate care better. Smaller hospitals in particular are wary of going it alone. Kaufman, Hall & Associates, an Illinois-based health care consulting firm, says there were 88 hospital mergers and acquisitions in 2011, the highest since 2000. The company is forecasting the pace will accelerate and the number of mergers and acquisitions may double over the next few years.

In Massachusetts, academic medical centers are reaching out to the suburbs and beyond. Partners Healthcare announced a closer relationship with South Shore Hospital of Weymouth in June. Massachusetts General acquired Cooley Dickinson Hospital of Northampton in February. And Beth Israel Deaconess acquired Milton Hospital in January. Lowell Hospital and Saints Medical Center, two smaller hospitals in Lowell, are merging. But the biggest change in the market has been the emergence of Steward.

Cerberus's Caritas deal, and its subsequent acquisitions, follow a similar pattern. Cerberus agrees to pay off existing long-term debt and, over time, start addressing the hospitals' pension liabilities and capital needs. The numbers are big—about $250 million in debt, $360 million in pension liabilities, and nearly $537 million in capital expenditures. (These numbers don't include any costs associated with the purchases of Nashoba Valley Medical Center and Merrimack, both of which were for-profit hospitals.)

Cerberus had invested $251.5 million in Steward as of September 30, 2011, according to documents filed by Steward in connection with its proposed acquisition of Landmark in Rhode Island. Most of that money probably went to retire debt. It's unclear whether Cerberus has invested more money in Steward, or whether Steward is drawing from its own cash flow to pay for capital improvements at its hospitals and to cover pension liabilities. Cerberus declined comment.

The capital commitments are very flexible. As part of the Caritas deal, Steward agreed to spend no less than $400 million on capital expenditures over four years. If it fails to reach that goal, Steward agreed to make a donation equal to the unspent amount to a charity chosen by the attorney general. But the definition of capital expenditure in the Caritas purchase agreement was extremely broad. Any expenditure "to promote the financial health, well being, or growth of the health system" would qualify, even money spent to buy another hospital.

Steward's hospital acquisitions brought with them considerable real estate. Property records indicate Steward now owns real estate across eastern Massachusetts with an assessed value of $599 million. As a for-profit, Steward must now pay property taxes on that real estate (nearly $20 million a year), but it can also leverage that real estate to raise money.

In April, Steward granted 99-year leases on 13 of its medical office buildings to an Arizona real estate firm for an up-front payment of about $100 million. Steward is now renting those same buildings back from the Arizona firm under 12-year leases. The terms of Steward's leases have not been disclosed. Steward has also not disclosed whether it kept the cash generated by the deal or the money went to New York and Cerberus's investors.

Murphy, the Steward spokesman, says Cerberus isn't charging Steward any management fees and is barred from borrowing against Steward assets for the purpose of paying dividends or distributions until late next year.

Documents filed in Rhode Island indicate Steward incurred a net loss of $57 million in fiscal 2011 and negative cash flow of $33 million. A consultant hired by the state of Rhode Island to review Steward's 2011 financials said they raised a number of red flags, but Murphy says the company is on track and expected to turn a profit this year.

"What is remarkable is that as Steward sits today, with 10 hospitals and 2,700 doctors, we are the only investor owned or publicly traded health care system in the United States with no long term debt," Murphy said in a statement. "Any individual knowledgeable in the health care field would understand Steward's financial situation."

## CHANGING PERCEPTIONS

Steward's biggest challenge may be marketing. The company has to convince patients to come to its hospitals for routine care instead of going to the big teaching hospitals in Boston. It's a tough sell because those teaching hospitals in Boston are regarded as among the best in the world, while nearly half of Steward's hospitals were close to going under when Steward bought them. Quincy Medical Center, in fact, was in bankruptcy.

Hospital rankings are controversial, but they reflect public perceptions. In its 2011-2012 ranking of the best hospitals in the Boston area, *US News & World Report* picked Massachusetts General, Brigham and Women's, and Beth Israel Deaconess as one, two, and three. MGH was also ranked No. 2 nationally. In Greater Boston, Steward's St. Elizabeth's tied for thirteenth and Steward's Holy Family in Methuen and Good Samaritan in Brockton tied for sixteenth. No other Steward hospitals made it into the top 25.

At a troubled hospital like Carney in Dorchester, the challenge of changing patient perceptions is daunting. Morales, Steward's strategy guy, notes there are several teaching hospitals and community health centers in close proximity to Carney. "The community, if it embraced Carney and its local physicians for routine care, which is 95 percent of what it does, would have a very vibrant hospital. But because most of the community still perceives that a better brand of care is over there," he says, pointing in the general direction of Massachusetts General, "almost 70 percent of that community chooses to go to higher-cost settings where they perceive a routine service is better even though the facts say it isn't."

Morales recognizes that Steward needs to change the perception of its hospitals, and that starts with fixing up facilities that were allowed to deteriorate by the previous owners. Steward has spent close to $200 million so far on a variety of projects, including new emergency rooms at Holy Family, Good Samaritan, and Saint Anne's; new operating rooms at Saint Anne's and Carney; a cardiac catheterization lab at Norwood Hospital; and a new radiation therapy center at St. Elizabeth's. Quincy Medical Center has received an infusion of $30 million in capital spending.

Steward is also running full-page newspaper advertisements trumpeting the savings available with its limited network health plan. The ads emphasize the Steward name rather than the names of the company's individual hospitals and represent an attempt to build a new brand associated with savings and quality care.

To steer more patients to its hospitals, Steward is aggressively adding doctors to its physician network, in several instances wooing them away from the networks run by Boston's big teaching hospitals. "The number one driver of where a person goes for care is the recommendation of their physician," Murphy says. Dr. Mark Girard, president of the Steward physician network, say his stable of doctors has grown 150 percent since January 2010, rising from 1,000 (400 directly employed by Steward) to 2,500 today (600 directly employed by Steward). Officials at other hospitals, some of whom have lost doctors to Steward, say the company is offering a myriad of financial incentives to physicians, including income guarantees and, in some cases, lavish salaries. But concrete examples could not be documented, and Girard says such tales are overblown.

To attract more patients, Steward is adding doctors to its physician network, wooing them away from the big teaching hospitals.

Girard says doctors are joining with Steward because the company offers them a number of ways to keep care in their local communities and improve their profit margins. A Steward-owned medical malpractice insurer offers lower rates. Grant and infrastructure money provided by Steward allows doctors to install electronic medical record systems at virtually no cost, Girard says. A Steward call center can handle appointments, scheduling, and other grunt work that previously was handled by workers in a doctor's office.

The Whittier Independent Practice Association in Newburyport, a group of 150 North Shore doctors, dropped its affiliation with Beth Israel Deaconess and joined Steward late last year. Whittier was followed a month later by the 90 doctors of Compass Medical, which operates practices on the South Shore and had been associated with Partners. Sources say a key factor in their defections was a global payment contract Steward had signed with Blue Cross Blue Shield of Massachusetts.

The Blue Cross contract capped what Steward would receive for providing care to patients, but the cap initially included a hefty growth factor, meaning Steward would receive more money for its care than it did the previous year. That growth factor would slowly be scaled back in each ensuing year of the contract. In essence, the contract was designed to allow Steward to adjust over time to the new payment approach rather than all at once. Sources say Steward gained a significant additional financial advantage when the economy tanked and health care spending in general slowed. Steward was left with a contract that brought in revenue that far exceeded its expenses, allowing it to share the wealth with doctors who joined with Steward. Officials at the doctors' groups and Blue Cross declined comment.

Morales said he wasn't familiar with the details of the Blue Cross contract. "Even if that was the case, credit to Dr. de la Torre for taking an incentive which most hospitals should have taken that actually rewards quality and rewards keeping costs down," Morales says.

As Steward seeks to change the public perception of its hospitals, there is a feeling of urgency, largely because Cerberus is probably hungry for a return on its investment and eager to disprove the naysayers who say the company will fail. There is also a desire to go national with the concept Steward developed in Massachusetts. De la Torre said as much earlier this year at the JPMorgan Global Healthcare Conference in San Francisco as he laid out his national vision for investors.

"In a world of Neiman Marcuses, we're OK being Filene's," de la Torre said, according to a report in The Boston Globe. "The key, when you're a regionally focused, community-based, accountable care organization, is to keep health care local."

What was probably lost on the audience in San Francisco was the fact that Filene's, once an iconic retailing brand of Massachusetts, no longer exists.