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Despite Distressed Assets, Private Equity Firms See Value in Healthcare

Written by Kathleen Roney | February 13, 2012

During 2011, healthcare mergers and acquisitions saw 980 deals worth a total of $227.4 billion, an 11 percent increase from $205.6 billion in 2010, according to an Irving Levin Associates report. The upswing in healthcare mergers and acquisitions is likely to continue into 2012 and even 2013. In light of national healthcare reform, hospitals and health systems are looking to cut costs and integrate services. As a result, the sectors of home-health, ambulatory surgery centers and physician practice groups may see the largest amount of consolidation and acquisition.

According to Brent Hill, JD, healthcare transactional attorney at Waller Lansden Dortch & Davis in Nashville, Tenn., decreases in healthcare reimbursement rates and the Patient Protection and Affordable Care Act are placing downward pressure on the healthcare sector, which is most likely causing the industry's increase in mergers and acquisitions.

Industry experts believe healthcare M&A will continue to see significant numbers in 2012, whether the transaction involves a hospital, a health system or another health organization. "There are many of areas ripe for consolidation," says Mr. Hill.

While hospitals will still see M&A transactions due to physician acquisition opportunities, hospital executives may be more focused on service integration causing increased acquisitions. More specifically, Mr. Hill believes four general areas may lead the industry in 2012 M&A dealings: ambulatory surgery centers, physician practice groups, urgent care and the home health industry. Additionally, Mr. Hill says it is likely that hospitals, healthcare companies and private equity firms will be purchasers of these organizations.

There have been more private equity firms investing in healthcare in 2010 and 2011 than in years past. Private equity players have been active in the hospital industry for many years, and in 2012, we should expect private equity to continue to be active in the hospital space and in home health and urgent care. Both the home health and urgent care industries are fragmented and ripe for consolidation.

In order to understand where private equity in healthcare may lead, it is important to know its past.

Two notable players are New York-based Cerberus Capital Management and The Blackstone Group. Cerberus Capital owns Boston-based Steward Health Care System and Blackstone Group holds majority equity in Tenn.-based Vanguard Health Systems.

Steward Healthcare System
Typically, Cerberus has not invested in healthcare. The company is better known for investments in pharmaceuticals, paper products, transportation and retail. For instance, in 2007, Cerberus purchased an 80 percent stake in auto manufacturer Chrysler.

Cerberus made its first healthcare investment with the purchase of Caritas Christi Health Care for $900 million in November 2010. Caritas was converted into a for-profit system and renamed Steward Health Care System. With the purchase of Caritas, Cerberus infused capital into the financially struggling health system.

According to Dan Grauman, MBA, president and CEO of DGA Partners, a healthcare finance and management consulting company, one reason private equity firms invest in healthcare is because they have multiple sources of readily available capital to satisfy the capital needs of hospitals and health systems. More and more, hospitals and health systems have been in need of capital. Private equity firms like Cerberus and Blackstone, can meet that need, hence, an influx in private equity healthcare investments.

As part of the Caritas Christi purchase, Cerberus provided $400 million in capital for infrastructure and technology improvements. Thus far, Steward is fulfilling the capital improvement pledge.

First, Carney Hospital in Dorchester, Mass., completed construction of a $10.2 million surgical suite consisting of three operating rooms in August 2011. And, Saint Anne's Hospital in Fall River, Mass., opened its new 13,000 square-foot emergency department earlier this month.

Following the conversion of Caritas Christi into Steward Health System, the system quickly expanded its reach in the region.

In December 2010, Steward completed a $21 million acquisition of two Massachusetts community hospitals: Merrimack Valley Hospital in Haverhill, Mass., and Nashoba Valley Medical Center in Ayer, Mass. Steward also pledged $19 million in capital improvements at the two hospitals.

Steward then tried its hand in the healthcare insurance arena with an insurance plan for use with Steward-affiliated physicians and facilities. Steward worked with non-profit Tufts Health Plan in Watertown, Mass., the third largest health insurer in Massachusetts, to create Steward Community Choice. The Massachusetts Division of Insurance approved the insurance plan in December 2011.

Finally, Steward is currently in the midst of acquiring Landmark Medical Center in Woonsocket, R.I. Approval of the deal has been complicated after state regulators deemed the Steward's first application submission incomplete.

Vanguard Health Systems
For-profit Vanguard, backed by The Blackstone Group, also invested in healthcare organizations. Vanguard acquired eight-hospital Detroit Medical Center in December 2010.

As part of the DMC deal, Vanguard took on $391 million in DMC's debt and assumed its unfunded pension obligations and malpractice liabilities estimated at $335 million. Vanguard also pledged $850 million in capital improvements for DMC.

This January, DMC broke ground on a $78 million cardiology facility. In November 2011, DMC's Huron Valley-Sinai Hospital in Commerce, Mich., opened a $7 million private-room orthopedic and neurosurgery unit. Both projects represent forward movement of Vanguard's $850 million pledge.

In June 2011, Vanguard was taken public in an IPO at $18 per share, bringing additional capital to fuel the hospital operator's aggressive acquisition strategy. As of February 2012, Vanguard was trading at $10.69 a share.

Vanguard Health also owns three health plans: Phoenix Health Plan, a Medicaid managed health plan; Abrazo Advantage Health Plan, a managed Medicare and dual-eligible health plan; and MacNeal Health Providers, a preferred provider network.

Blackstone Group's investments through Vanguard appear successful based on 2012 fiscal year earnings thus far. Vanguard's 2012 fiscal year began July 1, 2011. Vanguard's acquisitions increased their total earnings for the 2012 fiscal year by 61 percent from their 2011 fiscal year. The increase was largely due to patient revenue from its acquisition of Detroit Medical Center. Vanguard also recorded net income of $12.9 million in the quarter ended Dec. 31, 2011, compared with a net loss of $4.2 million in the second quarter of last year.

Cerberus and Blackstone appear to have been successful thus far, but the question remains — are they following a strong strategy that has escaped struggling facilities simply due to lack of access to capital, or are they an exception to the rule?

Mr. Grauman believes there are two reasons private equity firms invest in healthcare. First, private equity firms have multiple sources of readily available capital to satisfy the capital needs of hospitals and health systems.

Second, despite the challenges of distressed assets and variability in hospital performance across the U.S., private equity firms can see down the road to when an investment in healthcare may turn profitable. "Investors and private equity firms are attracted to the healthcare industry because of the growth that the healthcare reform law and expanding healthcare coverage is fueling," says Mr. Grauman.

There is also one overarching demographic trend down the road, which suggests movement towards increases in healthcare service demand: the aging of baby boomers. "Private equity firms can focus on the bigger picture and see longevity in hospitals and health systems," says Mr. Grauman. "Conventional wisdom is that with the increased consolidation in the healthcare industry, if you pick the right investment it will be attractive in the future," he says. A private equity firm can weather turn-around time and losses, so that a hospital investment has a high return in a few years — when the U.S. patient population is at a peak.

However, only some hospitals suggest a promising investment to private equity firms. The fundamentals for hospital operations need to be available in the market. According to Mr. Grauman, "the four M's" — market, medical staff, money and management — are elements a private equity firm would consider when evaluating a hospital or health system. "[Market, medical staff, money and management] need to be present for a hospital to operate successfully. The private equity firm needs to see that there are enough available physicians in the area and that the market has a sufficient patient population," says Dan Grauman. "There needs to be a reasonable opportunity for the hospital to succeed."

While Boston and New England have no shortage of competition with providers such as Partners HealthCare in Boston and Johns Hopkins in nearby Baltimore, Steward may have been drawn to the market's ability to attract and produce high quality physicians and perhaps the competitive advantage of offering lower-cost care when compared to the big AMCs.

Most often hospitals face distress for a small number of reasons such as management decisions, lack of insight into future trends or an absence of technological investments. Hospitals that would operate efficiently under alternate circumstances are better able to regain lost capital and are smart investments. Private equity firms, like Cerberus and Vanguard, can visualize the hospital's potential for a strong turn-around, says Mr. Grauman.

Whether a private equity firm is looking for a promising return or merely wants to meet the needs of the healthcare industry, private equity investments seen recently in the healthcare industry are likely to continue. The future is ripe for healthcare transactions as healthcare reform and increases in health coverage continue. With Cerberus Capital's Steward Health and Blackstone Group's Vanguard Health as precursors, time will tell if they have paved the way for other private equity firms or if they are merely an exception.

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