

# Health Systems, Private Equity, and the Government:

## It's Complicated

Market Corner Commentary  
September 10, 2024

By Wyatt Ritchie and  
David W. Johnson



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, hurdled toward [bankruptcy](#). Steward officially filed for bankruptcy on May 6, 2024.

As the Steward saga unfolds, [Axios reports](#) that "Congress is ramping up 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 by U.S. Representative Stephan Lynch of Massachusetts last January:

*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 healthcare.*

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, the home 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. It is these 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 fastpaced 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. Labor challenges continue to intensify. The need for new technology investments seems insatiable.

Already a marginally profitable business, the increasing percentage of lower-paying Medicare and Medicaid insured patients compounds the operational and financial challenges confronting hospitals. A growing number, particularly in low-income rural and urban communities, are closing. These closures often compromise equitable access to healthcare services.

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, etc.), consumerism and omnichannel 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 leadership typically lacks the business experience and network 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 that set of 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 implementation of 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 US 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 enormous capacity for acquisitions.

Much PE capital (around **\$1 trillion** over the last 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, med tech companies, and more. 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



### Cain Brothers House Calls Podcast

Listen to the related podcast from Cain Brothers, a division of KeyBanc Capital Markets.

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 outcomes, access and quality. 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

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.

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. Their best alternative was to sell Caritas Christi's assets to the PE firm Cerberus.

After the sale, Cerberus converted the system to for-profit status and rebranded 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 healthcare, 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 healthcare. In 2016, Steward sold its hospitals to the real estate investment trust, Medical Properties Trust (MPT), for \$1.2 billion using 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 like hotels and airlines. The MPT transaction not only infused new capital into Steward, it 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 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 its operating model worked well in New England, movement into so many new and compromised markets in such a short time period 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.

Steward's timing was also bad. The COVID pandemic wreaked havoc with operations even as the system remained operational to serve its local communities' needs. Post-pandemic, the combination of 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 promote 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 the 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 to achieve. What PE did for Steward, it can also do for other health systems focused on valuecreating 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.

## AUTHORS



**Wyatt Ritchie** is the Group Head and Managing Director, focused on mergers & acquisitions and capital raising for clients in the specialty physician practice management, multisite healthcare services, and post-acute care sectors. He is also a member of the firm's Senior Management Team. Wyatt joined Cain Brothers in 2010 with 23 years of experience advising both public and private companies in a variety of M&A, capital raising, and strategic advisory transactions. Select and notable transactions include the sale of North Carolina Retina Associates to Retina Consultants of America, the sale of HealthPRO Heritage to Wellspring Capital Management, the sale of Community Psychiatry to Centerbridge Partners, the sales of VitreoRetinal Surgery and Retina Consultants of Houston to Retina Consultants of America, the carve-out of Valor Healthcare from Concentra (Select Medical) to Trive Capital, Amulet Capital's formation of US Fertility, and the sale of e+CancerCare to Integrated Oncology Network.



**David Johnson** is the CEO of 4sight Health, a thought leadership and advisory company working at the intersection of strategy, economics, innovation and capital formation. Dave wakes up every morning trying to fix America's broken healthcare system. Prior to founding 4sight Health in 2014, Dave had a long and successful career in healthcare investment banking. He is a graduate of Colgate University and earned a Masters in Public Policy from Harvard Kennedy School. Employing his knowledge and experience in health policy, economics, statistics, behavioral finance, disruptive innovation, organizational change and complexity theory, Dave writes and speaks on pro-market healthcare reform. His first book **Market vs. Medicine: America's Epic Fight for Better, Affordable Healthcare**, and his second book, **The Customer Revolution in Healthcare: Delivering Kinder, Smarter, Affordable Care for All** (McGraw-Hill 2019), are available for purchase on [www.4sighthealth.com](http://www.4sighthealth.com).

## DISCLAIMER

*The information contained in this report was obtained from various sources, including third parties, that we believe to be reliable, but neither we nor such third parties guarantee its accuracy or completeness. Additional information is available upon request. The information and opinions contained in this report speak only as of the date of this report and are subject to change without notice.*

*This report has been prepared and circulated for general information only and presents the authors' views of general market and economic conditions and specific industries and/or sectors. This report is not intended to and does not provide a recommendation with respect to any security. Cain Brothers, a division of KeyBanc Capital Markets ("Cain Brothers"), as well as any third-party information providers, expressly disclaim any and all liability in connection with any use of this report or the information contained therein. Any discussion of particular topics is not meant to be comprehensive and may be subject to change. This report does not take into account the financial position or particular needs or investment objectives of any individual or entity. The investment strategies, if any, discussed in this report may not be suitable for all investors. This report does not constitute an offer, or a solicitation of an offer to buy or sell any securities or other financial instruments, including any securities mentioned in this report. Nothing in this report constitutes or should be construed to be accounting, tax, investment or legal advice. Neither this report, nor any portions thereof, may be reproduced or redistributed by any person for any purpose without the written consent of Cain Brothers and, if applicable, the written consent of any third-party information provider.*

*"Cain Brothers, a division of KeyBanc Capital Markets" is a trade name of KeyBanc Capital Markets Inc. Member FINRA/SIPC.*

*KeyBanc Capital Markets Inc. and KeyBank National Association are separate but affiliated companies. Securities products and services are offered by KeyBanc Capital Markets Inc. and its licensed securities representatives. Banking products and services are offered by KeyBank National Association. Credit products are subject to credit approval. Copyright © 2024 KeyCorp.*