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PE's Healing Touch Faces Test In Hospital Buys

By **Samuel Howard**

Law360, New York (February 08, 2012, 5:54 PM ET) -- Stubbornly inefficient and increasingly indispensable, health care systems are big game in today's private equity scene as savvy investment firms hunt for turnaround opportunities. But deal makers have to run a murky gauntlet if they want to make the sector pay, private equity lawyers said.

Distressed buying opportunities in health care are expected to increase as the municipal bond market remains tight and cash-strapped hospitals turn start looking to other sources of liquidity, such as private equity firms. Possible cutbacks in Medicaid also could put the squeeze on large hospitals, attorneys said.

"Most of the country's not-for-profit health care systems will have to do more with less reimbursement from the government," Ira Coleman of McDermott Will & Emery LLP said. Meanwhile, hospitals are feeling pressure to invest in expensive medical equipment and information systems in order to stay competitive, he added.

"It's the proverbial perfect storm — capital demands are increasing dramatically at the same time reimbursement is decreasing," Coleman said.

Already, big private equity players have made bold moves in the health care arena. Cerberus Capital Management LP in 2010 acquired Caritas Christi Health Care from the Archdiocese of Boston for roughly $900 million. The firm augmented the network with four more hospital acquisitions and made a $1.1 billion bid for a financially distressed, government-owned system in Miami.

In the same year, The Blackstone Group LP's Vanguard Health Systems acquired a nine-hospital nonprofit system in Detroit and committed $850 million to revive the network. And in February 2011, Oak Hill Capital Partners LP formed a joint venture with Ascension Health, the nation's largest Catholic health system, to invest in downtrodden hospitals.

Private equity firms see the potential to capture huge savings in these types of investments in that they can use their turnaround talents to root out waste and overhaul dated technology, Eric Klein of Sheppard Mullin Richter & Hampton LLP said.

"Expertise and capital applied at the right pressure points at the right time can make a major difference and lead to major returns," Klein said.

Those returns, however, will be hard to win in a sector that remains technologically backwards, overrun with regulations and tied to federal purse-strings, attorneys said. Firms cannot just parachute into the sector and finesse deals as they might in other markets, the experts said.

Regulation, for starters, is one serious obstacle for investors in the health care field, attorneys said. The sector is heavily regulated and noncompliance carries crippling penalties, they said.

There are state and federal reimbursement rules, broad prohibitions on the corporate practice of medicine, strict ethical rules for doctors, and a slew of other professional and hospital regulations, attorneys said.

“You can’t be too careful on regulatory compliance,” Coleman said. “The regulatory regime is so draconian, a minor slip has major consequences that can easily derail a health care venture.”

That means exhaustive due diligence to ensure that all reimbursement applications are kosher, all tax and insurance practices are watertight, and professional conduct is irreproachable, to name a few compliance necessities.

But regulatory sleuthing is only half the battle. Understanding the business side of health care and what strategies would be best suited for the sector can also prove daunting, attorneys said.

“You need look retrospectively and make sure you’re not buying a radioactive asset, but you also need to take a rigorous prospective approach and understand what business model will work,” Klein said. “It’s not what worked yesterday, but what will work tomorrow. And that’s no easy feat in an unpredictable environment.”

For all the nitty-gritty of financial modeling and cost capturing, private equity firms also need to negotiate credos in the nonprofit sector that rarely color the boardroom.

Hospitals and care centers often carry a religious affiliation, so corporate decisions may require approval of an archdiocese or otherwise align with community considerations, according to Felicia Perlman of Skadden Arps Slate Meagher & Flom LLP.

“The health care services sector often involves a complex regulatory regime as well as a mission-based or religious overlay alien to other industries,” Perlman said.

While a viable business model is key to any turnaround, the circumstances of the health care sector — which is struggling to modernize, adapt to a consumer market and implement historic reforms — make it particularly difficult to accomplish, Klein said.

Even though hospitals speculate that between 8 and 15 percent of their revenue is lost through inefficiencies or redundancies, the industry is unable to fully track and systematize its performance.

At the most fundamental level, hospital systems are hard to streamline because it their costs are improbably difficult to quantify and their revenue flow is so mediated, diffuse and indirect.

“The revenue model is uniquely convoluted and often does not make logical business sense,” Klein said. “How many industries have per-member per-month payments, risk-sharing arrangements, bundled payments, co-payments, deductibles and other fee structures?”

In short, it's very hard to identify weaknesses and improve a business when the baseline information is itself obscure or inconsistent.

“You’d think that hospitals could manage and project costs and revenue, but the quality of their modeling varies wildly,” Sam Zucker of O'Melveny & Myers LLP said. “As a threshold matter, it’s very difficult for buyers to get their arms around what they are buying.”

Given the regulatory uncertainty and the importance of the government’s reimbursement policies, business decisions can carry substantial risks.

“If a procedure or a device turns out not to be readily reimbursable, it becomes a cost and cost management makes the difference between a salable company and a white elephant,” Zucker said.

But the deficiencies making hospitals hard to turn around — the archaism of its record keeping and technological lag — are precisely what makes it a great investment opportunity, attorneys said. Private equity firms might be able to do it if they anticipate innovations and implement them while harnessing consumer behavior and health trends, they said.

Another impediment to private equity deals in health care could be the health care organizations themselves, which may consider profit motives to be at odds with their goals, particularly if they are not-for-profit or religious health care institutions. But those groups are starting to become more open to private equity investment as they struggle with their finances, attorneys said.

“There is a tension between maximizing profits and the mission, but there has been a growing recognition that if you don’t have liquidity, you can’t reach your mission, so private equity is not encountering the resistance they once might have met,” Perlman said.