The Deal

How PE Could Be the Cure Hospitals Are Looking For

Downtrodden share prices and other factors may provide financial sponsors with a buying opportunity.

September 16, 2016

By and large, traditional private equity has shied away from new investments in hospital companies over the last few years, preferring to inject capital in more promising areas of growth such as behavioral health, healthcare technology and contract research organizations that fuel drug development.

With an abundance of more obvious opportunities in which funds can carry out a so-called buy-and-build strategy, financial sponsors in recent years can be best identfied as net sellers of hospital companies. But with vulnerability comes opportunity, and according to industry experts, some investors may be re-evaluating their theses.

Apollo Global Management LLC, for instance, represents the only new capital to come into the sector recently, but Matt Nord, a partner at the New York PE firm and a member of the board of directors at RegionalCare Capella Healthcare (RCCH)- the result of a merger Apollo helped engineer in March-said he suspects "other sponsors are starting to update their analysis."

To be sure, PE firms in recent years have tired of their hospital companies in their portfolios.

"A lot of these private equity funds are saying, 'hospitals have had a strong run and the market is going to get a little more difficult ahead'-and so they're focusing on higher growth areas," said Gregory Hagood, who as a senior managing director and president heads up the healthcare practice at SOLIC Capital LLC. "Many healthcare- focused PE firms are looking elsewhere."

Problem is, sponsors have had problems unloading their hospital holdings. TPG Capital, for example, attempted to sell what is now a more than 12-year-old investment in Iasis Healthcare Corp. in 2012, The Deal reported at the time. A deal never came to fruition, however. So the Fort Worth- and San Francisco-based firm, alongside minority investors JLL Partners Inc. and Trimaran Capital Partners, in February 2015 figured they'd exit another way: they filed a preliminary prospectus to take the hospital company public. That, too, hasn't happened yet.

Leonard Green & Partners LP-backed Prospect Medical Holdings Inc., late last year reportedly hired Morgan Stanley & Co. to explore a potential sale. And Cerberus Capital Management LP's investment in Steward Healthcare System LLC is growing increasingly long in the tooth, having purchased the community-based healthcare system in 2010 for $830 million.

Indeed, only Blackstone Group LP-backed Vanguard Health Systems Inc. actually did find a buyer-Tenet Healthcare Corp.-in a $4.3 billion deal in June 2013.

Weighing on the sector is the simple fact that hospitals represent the highest cost site of care at a time when the market is pushing for greater efficiencies and lower costs, according to Kara Murphy, who as a partner in Bain &

Co.'s Boston office co-leads the firm's healthcare private equity team. There's also continued uncertainty around reimbursements amid the shift to value-based care from the traditional, fee-for-service model, and concerns around how Presidential election could impact The Affordable Care Act, she said.

"If you're a growth-oriented private equity investor, it's a heavy lift and contrarian play to go invest in hospitals," Murphy said. "Private equity is getting the option to look at everything."

But even as most traditional firms continue to opt for alternative opportunities in healthcare, industry pundits suspect there remains pockets of opportunities for certain segments of the investment community, and especially as the equity markets prove challenging for some public hospital companies. It also helps if there is some smart money to follow, and among PE firms in the healthcare space, Apollo may fit the bill.

It was Apollo-backed RegionalCare Hospital Partners Inc. in March that combined with Medical Properties Trust Inc.'s (MPW) Capella Healthcare Inc. to create a $1.7 billion-in-revenue hospital system giant, only months after the REIT bought the healthcare services company from Chicago financial sponsor GTCR LLC. The combined entity now goes by RegionalCare Capella Healthcare (RCCH) and is based in Brentwood, Tenn.

Medical Properties said in March that net proceeds from the transaction would be approximately $550 million, having spent $900 million in cash to acquire Franklin, Tenn.-based Capella from GTCR less than a year earlier. Meanwhile, the transaction came just four months after Apollo purchased RegionalCare from Warburg Pincus LLC for an undisclosed sum.

Both RegionalCare and Capella were older investments for both Warburg and GTCR, respectively, suggesting each sponsor was unlikely to inject additional capital in the two hospital operators.

Curiously, these and other PE firms saw their opportunities in the sector when hospital stocks traded down in the mid-2000s. Financial sponsors took a bunch of for-profit operators of health care facilities private. Once the Affordable Care Act took effect in March 2010, it fueled a huge run for the hospitals, and up through 2015 that bode pretty well for the sector's backers, SOLIC's Hagood explained.

"We saw a bunch of smart private equity money come in and buy up hospital assets," Hagood said. "We saw good returns for the public investors and private equity guys."

Perhaps the most notable of deals was the leveraged buyout of HCA Holdings Inc. (HCA). The hospital company in July 2006 agreed to a $33 billion LBO by a consortium that included Bain Capital LLC, KKR & Co. and Merrill Lynch Global Private Equity, the private equity arm of Merrill Lynch & Co. At the time, the deal represented the largest LBO transaction in history. The for-profit hospital operator's financial backers in 2011 raised $3.79 billion in HCA's third IPO, and have continued to reap impressive rewards as they sell off their stakes in the years since.

History may repeat itself, Hagood asserted, as a sector-wide pullback in the public markets may attract PE investors who see a distressed, value proposition emerging. "We may see one or two deals come back around," he noted.

Recent stock performance suggests that a couple players may soon look like LBO prospects, Hagood said.

While he declined to comment on potential targets, publicly traded hospital companies that have suffered in recent months include Quorum Health Corp. (QHC), whose shares have lost more than 50% of their value since the rural health business completed its spin off from Community Health Systems Inc. (CYH) in May, trading at about $6.43 on Monday. Rumors that Community Health was up for sale were circulating at press time.

The equity markets also haven't treated Community Health well since the breakup. Shares of the company have fallen about 41% to $11.23 a share since April 29, the last trading day before the completion of the spinoff was announced.

There's also LifePoint Health Inc. (LPNT), the Brentwood, Tenn., operator and owner of hospitals and healthcare services in non-urban communities. LifePoint's stock has retreatred about 20% this year, trading at a recent $58.43.

"There's a lot of vulnerability," Bain's Murphy said. "That creates an opportunity for consolidation."

A bullish case can be made for a certain segment of private equity, Murphy said, especially when it comes to facilities succumbing to cost pressures even as people need hospitals to go to. "The RegionalCares of the world were built up by buying underperforming hospitals and turning them around," she noted.

Apollo's private equity arm seeks opportunities in large sectors that line up with the size of its $18 billion fund, which outside of healthcare invests in various industries. At the same time, Apollo's style is a bit contrarian, said the firm's Nord, explaining that by going after companies in sectors which traditional sponsors may not be focused on, it's less likely to overpay for an asset as one might in an auction scenario.

"Not a lot of others are doing it," Nord said of investments in hospitals. "That's one of the reasons we got excited."

Nord said it was really obvious that RegionalCare and Capella belonged together.

"The two companies had talked about merging in the past," he explained. "By bringing in new capital, we are facilitating a lot of transactions that should have happened already."

The growth strategy for RCCH is two-pronged. RCCH will look to expand in its existing markets in which it serves as the No. 1 or No. 2 player, or within new markets that have a similar profile in a growing market with good demographics, Nord said.

"Now we've got a business that's more than double the size of what we started with," Nord said. "Dislocation in the equity markets is creating even more opportunity for us. We're competing with some of the public companies and we feel like we're the go-to acquirer. Our phone literally rings off the hook with different opportunities. We can be really selective."

Rural hospitals, meanwhile, may present opportunities for another set of investors, according to Hagood.

While not particularly appealing to traditional PE firms, hedge funds and institutional investors are increasingly bidding on troubled rural hospitals. These investors are finding that rather than spending $25 million or so for a nice suburban hospital, a network of six or 10 hospitals can be created by picking up assets in rural communities in states in the Midwest or the Southeast states for a couple million or so a piece.

"The guys that have been very successful in running a chain of suburban hospitals are not necessarily good at running the rural hospitals," Hagood said. "Those opportunities are out there. For people that understand that market, there's a nice opportunity for them."

Hagood is currently advising on three different deals of this type, including one for Pioneer Health Services Inc. The Magee, Miss.-based provider of healthcare services to rural communities filed for Chapter 11 bankruptcy protection on March 31 in the U.S. Bankruptcy Court for the Southern District of Mississippi in Jackson.

Pioneer operates three critical access hospitals and provided management services to several others. Despite being in bankruptcy, the company has attracted interest from a broad range of parties, from regional health systems to hedge funds and specialty healthcare companies, Hagood said. Pioneer represents an opportunity to acquire a rural health care provider with some scale and infrastructure and the 363 sale process allows for a clean transaction.

Pioneer has blamed its money troubles on delayed Medicare and Medicaid reimbursements and the costly forced implementation of a new software program for electronic health records at its facilities.

One swath of the hospital sector that doesn't figure to provide PE with much opportunity at all are the nonprofits.

For an investor looking to turn a profit typically within a certain timeframe, nonprofits are problematic from both a charitable and tax perspective. These types of hospitals don't pay federal income or state and local property taxes and have goals that tend to clash with those of the typical financial sponsor.

Large consolidators such as Universal Health Services Inc. (UHS) have successfully partnered with not-for-profit hospitals, which are arguably less prepared for the industry movement away from a traditional fee-for-service model to a risk-based model.

As value-based healthcare reimbursement programs expand, "PE firms may view this as an opportunity to use their operational experience to implement cost-saving measures, while continuing to provide quality care," said Deborah Gersh, a partner and co-chair of the healthcare practice group at Ropes & Gray LLP.

In other words, as hospitals continue to assume more risk-traditionally the roleinsurance companies have played-states are searching for ways to help failing hospitals in rural markets deal with financial burdens, Gersh explained.

"That's where the interesting play is going to be," Gersh said. "Can others come in and manage that risk better?"

With the shift to value-based care still in its early stages, it will probably be several years until the market shakes out a bit and we see this kind of activity, Gersh said.

"When you look at the investment side," she added, "the first to move wants to see some evidence that this will work."

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