

THE BILL THAT WILL EFFECTIVELY LEGALISE FRAUD

As the government looks to open up the NHS further to private companies, it has been as coy in its description of the companies looking to profit from this as the companies themselves. Health Secretary Andrew Lansley hardly mentions that these companies will be making a profit from his reforms, preferring to talk about modernisation and bringing 'the power of competition to healthcare'.^[1] H5, the pressure group set up by five of the biggest private healthcare companies in the UK, and an increasingly prominent voice in the media, says its members are 'dedicated to better healthcare for Britons through private hospitals playing their part complementing the NHS'^[2], while the NHS Partners Network, which represents private companies and some not-for-profit groups, is only a little more direct in its assertion that a 'mixed economy NHS' will lead to, 'more choice and better value for money for patients, taxpayers and shareholders'.^[3] That the satisfaction of each of these three groups is not mutually compatible has been well argued (see, for example, here) but the fortunes of Southern Cross over the last month suggest this is an especially severe imbalance when the shareholders concerned are private equity firms.

Since its announcement in the middle of March that high rents and government spending cuts had left it financially unsustainable, Southern Cross has been scrambling around trying to renegotiate its rents while councils have been readying themselves for the possibility that 30,000 elderly people will be without a bed if the real threat of the company going under is realised. The crisis was precipitated by local authorities passing on less 'business' to the company: as the cuts bite one of the ways they are saving money is by paying for fewer people to stay in nursing homes. However, the company was especially vulnerable due to, in the words of Chief Executive Jamie Buchan, 'the type of lease arrangements which underpin our business model.'^[4]

This business model was mainly the consequence of its brief period of ownership by the Blackstone group, one of the world's biggest, and most successful, private equity investors. After it acquired the company in 2004, Blackstone gave an object lesson in how private equity works: it expanded the company as fast as it could, then sold it, making a lot of money but leaving a lot of problems. Two months after buying Southern Cross, it bought the property company NHP's 355 care homes as well, followed by the 193 homes of the Ashbourne Group in November 2005, all to be managed by Southern Cross Healthcare. Blackstone then floated the company on the stock market and sold its shares in two chunks, in 2006 and 2007, walking away with reportedly quadruple its original investment, not bad for just three years of ownership.

The problem is that Southern Cross now owns very few of the freeholds to the care homes it is operating, and the landlords that now own them are charging rents the company cannot afford. This is not all due to Blackstone – Southern Cross had already sold the freeholds to most of the homes it owned before Blackstone took over – but the acquisition of NHP and the way it was sold saddled Southern Cross with even more unsustainable rent bills. Although it floated Southern Cross Healthcare on the stock market in 2006, Blackstone sold the freeholds of the old NHP care homes separately, to an investment fund for £1.3bn. Southern Cross continued to manage

these homes, as it did when Blackstone made the initial acquisition of NHP, but it now had to pay rent to the new owners for the privilege. The residents of these homes weren't helped by Blackstone's choice of buyer: the Qatari Investment Authority, which, since buying the homes, has increased rents by 18.6%. [5] All in all, the GMB union, which represents Southern Cross staff, estimates that with Southern Cross paying £248.3m to the landlords of all of its 752 homes (including those owned by Qatari Investment) in 2010, its rents are £100m higher than they should be. [6]

So while some people have got very rich from the trading of elderly people's need for a secure, safe and comfortable place to live, it hasn't worked out too well for everyone else. Even before this present crisis, Southern Cross was being heavily criticised for the standard of its service. It was forced to make a public apology last November after an investigation by the BBC found a 'catalogue of distressing lapses in care' [7], while the company's Griffin Care Centre in Luton had to be closed in January this year after an investigation by the Care Quality Commission found 'risks in relation to medication' and, 'gaps, omissions and failings in the way medicines were managed.' [8] And while Blackstone made huge profits from the deal, many of the staff working in the care homes are paid the national minimum wage and have had their pay frozen. [9]

Who is private healthcare working for?

The concern is that there will be more cases like Southern Cross in years to come. The government is entrusting more and more responsibility for healthcare to companies owned by private equity, or at risk of being so. Care UK, which already operates NHS walk-in centres, GP surgeries and treatment centres around the country was bought by Bridgepoint private equity group in 2010. Spire Healthcare, the second largest private hospital provider in the UK, is owned by Cinven private equity, and HCA International, the largest operator of private healthcare facilities in the US and which has six private hospitals in London, is majority owned by Kohlberg Kravis Roberts & Co (KKR), Bain Capital and Merrill Lynch Bank of America private equity groups (see below).

It is not just private hospitals and direct care providers. Blackstone bought Pulse, the staffing agency for doctors, nurses and social workers last November and merged it with ICS, a rival healthcare recruitment agency it had bought in June in a bid to create a market leader in healthcare recruitment through an expansive acquisitions policy (sound familiar?). [10] In addition, NHS Professionals, the currently state-owned staffing agency, is thought to be likely to attract private equity bids when it is privatised this year, as planned by the government. [11]

People across the health reform process have links with private equity companies. Former Labour Health Secretary Patricia Hewitt has been an advisor to Cinven; Andrew Lansley, the current occupant of that post, received funding from the wife of John Nash, a private equity tycoon and former chairman of Care UK; and Lord Carter, the head of the increasingly influential Competition and Cooperation Panel, is an adviser to Warburg Pincus International Ltd, a private equity firm with significant investments in the healthcare industry. [12]

This is especially worrying for the NHS because Southern Cross is not the first company to have been left exposed following ownership by private equity investors. Private equity firms have a history of acquiring companies using borrowed money, expanding them quickly, again with borrowed money, then selling them off and counting their profits while the company starts to creak. The activities of this highly secretive pool of capital have led to charges of vulture capitalism and asset stripping, with multiple instances of large scale job losses in the companies it takes over.

Private equity: the basics

Over the past decade, private equity firms have generated both astonishingly large profits and a large amount of controversy. At the industry's height prior to the credit crunch it was called the new 'face of capitalism'[13], mobilising huge sums in company buy outs and generating enormous profits by utilising the glut of cheap credit provided by low interest rates after the dot.com crash. The total, global value of private equity deals in just one year - 2006-7 - came to \$1.4 trillion, whilst the five biggest deals made in April 2007 involved more money than the annual public budgets of Russia and India.[14]

Equity investment is, put simply, owning shares in a company. Private equity is a specific type of equity investment which goes much further than buying and selling shares in companies. Private equity firms take up majority share ownership in companies with the aim of taking them private - i.e. de-listing them from public stock exchanges – if they are not already. They take management control of the companies they buy, with their fund managers joining company boards and often presiding over serious 'restructuring' of those companies. Ultimately, they seek to sell such companies on at a profit as quickly as possible. To minimise cost, such 'restructuring' invariably involves reducing staff, closing plants, and selling off non-core assets. This is all done behind closed doors, with the companies' 'private limited' status removing them even further from public scrutiny and regulatory demands.

Debt overload

Private equity firms buy companies with large-scale, debt-financed buyouts. Called 'leveraged buyouts' (known as LBOs in the trade), companies to be acquired would be used as collateral against which a private equity company would borrow the large sums needed to buy them out. The debt would then be placed onto the acquired company's books, allowing the private equity company to avoid taking the debt on itself, and repaid from the bought-out company's profits and assets. Typical private equity leveraged buyouts would comprise 80 per cent debt and 20 per cent equity provided by external investors in the private equity fund, such as pension funds and hedge funds. The period prior to the financial crisis, with low interest rates and correspondingly cheap credit, allowed private equity companies to borrow large sums: between 2004 and 2007 loans totalling \$450bn were used in leveraged buyouts.[15]

Leveraged buyouts are, however, a gamble that the interest paid on the debt will be lower than the returns made on the investment, increasing the pressure to both asset strip and sell companies on as fast as possible once the appearance of enhanced profitability has been given. During the credit crunch the glut of cheap credit dried up and lenders started re-calling loans, dramatically reducing the levels of private equity

buy outs. KKR, one of the world's largest private equity firms, did not undertake a single buy out in the first half of 2008.[16] With some companies struggling with slowed economic 'recovery', and refinancing of much of this debt looking problematic, the private equity model of leveraged buyouts has been revealed as the emperor with no clothes: with the boom times over, investors appear over extended, holding companies laden with debt and struggling to cope. Whilst private equity companies can more easily sell the company off and move on to their next acquisition, the gamble looks less sweet for the other side, threatening redundancy for employees of debt-laden and 'restructured' companies.

Healthy opportunities

However, in the last year credit has started to flow again, and private equity has made a partial recovery, though not to pre-credit crunch levels. It seems that healthcare in particular will continue to be popular with investment funds. Everybody needs it after all and, with the cuts to public spending already limiting the services offered by the NHS, there is increasing demand for private care, which will be additionally aided if the coalition's healthcare reforms go through and further open the NHS up to private involvement.

Private equity firms invested \$2.1bn in private healthcare companies in the first quarter of 2011 alone[17] and, looking at the recent fortunes made through HCA International, it is easy to see why. The US healthcare company, which runs six private hospitals in London and is currently pushing for more business within the NHS, was bought out by a trio of private equity companies, KKR, Bain Capital and Merrill Lynch (now owned by Bank of America), for \$33 billion in 2006. As is typical of private equity, this was financed, for the most part, by borrowed money: the three firms contributed \$3.8 billion in equity and leveraged the other \$29 billion as debt. At the time it was the largest leveraged buyout on record.[18] The private equity trio continued to saddle HCA with debt, much of which went towards the payment of fees and dividends to themselves and their investors, partially as a means to attract investment to future funds and partially as a result of the typically short-termist management techniques of private equity companies. In both February and May 2010, dividends were paid out after HCA took on more debt by borrowing from its revolving credit facilities and by September 2010 the company had \$409m more debt than the year before: a total of \$26.1 billion.[19] This did not deter it from announcing the sale of \$1.53bn worth of bonds to finance a \$2bn dividend to its private equity owners in November 2010. Having wrung payouts of \$4.25bn out of the company in just one year, it was listed on the stock market in February 2011, making \$3.8bn and creating \$10bn in equity value for KKR, Bain Capital and Merrill Lynch (now part of Bank of America).[20]

The justification made for private equity firms is that, by buying up companies when they are 'distressed' - in financial difficulty and with a correspondingly low share price - they act as wardens of a healthy economy. The threat of private equity buy-out should help keep companies behaving in the best financial interests of their shareholders[21] and by providing management 'expertise' private equity companies supposedly return 'distressed' companies back to health, granting them an increased ability to create profit. Harry Cendrowski, author of *Private equity: history, governance, and operations*, puts it thus: "The institutionalisation of private equity is,

perhaps, one of the most important advances in the field of modern finance: it is through private equity (PE) that the seeds of new ideas are permitted to germinate and the souls of the withering may be granted rebirth.”[22]

However, it is doubtful that, with more debt on its books, HCA will be better at managing hospitals, and especially NHS services, in which the profit margins will not be as high (and HCA’s record in the US, before it was bought by private equity wasn’t exactly inspiring).[23] Commenting on the payouts, Josh Lerner, professor of investment banking at Harvard Business School, euphemistically stated 'There’s a tension between what’s in the best interest of companies and what’s in the best interest of investors', neglecting to mention the more severe tension patients in HCA wards will feel if the debt proves too much for the company.

Fortunes? Yep.

The money made from HCA is not unusual. Saddling bought-out companies with increased debt to make regular, and massive, payouts in fees and dividends, is standard practice. Surveying the 47 largest private-equity-owned UK companies in 2009, the British Private Equity and Venture Capital Association (BVCA) found that of the aggregated £13bn increase in debt held by those companies following private equity buyout, £2bn was paid as dividends to private equity fund managers and investors.[24]

The personal wealth amassed as a result of this by private equity fund managers is both astounding and revealing. In 2011, 65 of the 1,210 billionaires included in Forbes’ rich list are private equity and hedge fund managers. Among the most notable members of this elite group are the co-founders of the private equity firm Kohlberg Kravis Roberts & Co (KKR) - Henry Kravis and George Roberts - who each hold personal wealth of \$3.9bn. Both Kravis and Roberts received ‘carried interest’, a performance fee typically based on 20 per cent of profits generated, of \$19.5m for 2010 alone.[25]

Taxing? Not very.

In their pursuit of driving down costs, private equity firms are notorious tax avoiders. As well as its share in ownership of HCA, KKR owns Alliance Boots, including Boots the Chemists, who are bidding to take on a wider range of NHS services. It was revealed in January 2011, for example, that they were in talks with the Department of Health about offering chemotherapy and phlebotomy - the taking of blood samples and other bodily fluids for analysis – services to NHS patients from its high street stores.[26]

However, their tax returns suggest they may not be as committed to public service as they like to suggest. KKR acquired Alliance Boots in June 2007 in a massive leveraged buyout, naturally, worth £11.1bn, of which £9.3bn was borrowed from banks and investors. Tax avoidance has been a feature of many private equity 'restructurings' and in 2009, KKR transferred Boot’s headquarters from England to Switzerland to take advantage of the tax haven of Zug. Prior to the buy-out, Boots was paying on average one third of its profits in tax to the government: about £150m a year. By March 2008 it was so saddled with debt and having to pay out £606m in net

finance costs for 2007-08, that it made a pre-tax loss of £64m. In 2009, though it was back to profit, but of the £475m it made, only £14m was paid in tax. John Ralfe, the former head of corporate finance at Boots, told the Guardian that 'the UK has lost about £100m a year in tax'.

Cut costs, cut jobs

Whilst renowned for granting large personal fortunes to its managers, private equity is also renowned for causing job losses, overriding benefits packages, taking up anti-union positions, and ignoring collective bargaining in its short-term race to cut costs and amplify profits. The experience of Gate Gourmet, the airline catering company, is well known. The company was bought from SwissAir by private equity firm Texas Pacific Group in 2002, following SwissAir's bankruptcy.

Texas Pacific quickly pursued a 'restructuring' programme for Gate Gourmet, which included mass job cuts. By 2005, Gate Gourmet had shed 3,000 jobs, whilst management experienced pay increases. After offering redundancy to 630 workers in Heathrow in June, none of whom agreed to it, the company hired 120 non-unionised contract workers at substantially lower rates of pay and with much worse employment conditions. Responding to this, workers assembled for a meeting and were promptly given a three minute warning to return to work. When many refused, an announcement was made, via megaphone in a Heathrow car park, that 800 Gate Gourmet workers were to be sacked, leading to one of the largest industrial disputes in recent UK history (see an interview from the time here).

Care UK, owned by Bridgepoint private equity, has shown healthcare jobs are not immune from such 'restructuring'. Eight days after winning a £53m contract for prison healthcare in the north-east earlier this year, it promptly unveiled a restructuring plan affecting 116 out of about 400 employees and announced there would be job losses, causing a Royal College of Nursing representative to lament its 'worst fears' were coming true.[27] Indeed, counter to the industry's own claims, private equity ownership very rarely leads to job creation. According to the BVCA report cited above, employment at private equity owned companies grew by only 0.1% in 2009, well behind the 5.2% figure for non-private equity owned companies.

NHS exposed

The risks carried by companies owned by private equity will become especially dangerous if the coalition's health reforms are passed and these companies are allowed to take more NHS work. When they are operating on clients who can afford the fees in their private hospitals, the consequences of indebtedness and over-expansion are less urgent, as the patients can go to another hospital or wait for their treatment on the NHS. However, if the coalition's reforms are passed, and the companies are allowed into the heart of the NHS, the consequences are potentially severe. A regular concern of practitioners has been that if a company is commissioned to do lucrative procedures such as, say, hip replacements ahead of the NHS hospital that used to do the work, that NHS unit won't be able to carry on. But if the company that takes over then finds itself in financial trouble after its private equity holders have taken its money and run, the NHS won't be able to pick up the slack anymore and there will be far less of a public safety net for people who still have dodgy hips.[28]

Of course, asset-stripping, job cuts and risky financial strategies are not limited to companies with private equity investment - South African healthcare giant Netcare, and global investment fund Blackrock, owners of major private players BMI Healthcare and Circle respectively, aren't known for their public spiritedness[29] - but the fact that a good number of health companies set to benefit from the reforms are owned or have been owned by private equity firms gives the lie to the government's rhetoric around its reforms. David Cameron, Nick Clegg and Andrew Lansley have all been at pains to stress that their reforms will make the NHS more accountable to its patients but, given the type of companies they are encouraging to get involved, this is disingenuous to say the least.

If we criticise the privatisation brought in by the reforms by only talking about healthcare companies, we neglect the companies behind them. Investment in private healthcare does not simply come from individual shareholders but investment companies designed principally to extract as much wealth as possible, as quickly as possible, and which, in the case of private equity, have taken management control of bought-out companies to ensure that happens. This gives the lie both to the companies' presentation of themselves as friendly and wholesome providers who have worked out a way to deliver healthcare that is better for everyone, and to the coalition's claims that their reforms will make the NHS more accountable. Private equity firms are not investing in healthcare companies to help them deliver healthcare to people regardless of their capacity to pay. Letting those companies further into the NHS makes sense only for their investors.

References

[1] www.guardian.co.uk/healthcare-network/2011/jan/25/nhs-private-independent-healthcare-lansley-health-bill

[2] www.h5health.org

[3] www.nhsconfed.org/Networks/NHSPartners/Pages/aboutnhspartners.aspx

[4] www.shealthcare.co.uk/News-and-Events/2011/Message-from-Jamie-Buchan-Chief-Executive-of-Southern-Cross-Healthcare

[5] Owned by the Qatari government it has recently added Harrod's to its list of purchases, which also include significant shares of Barclays, Sainsbury and Porsche. see www.gmb.org.uk/newsroom/latest_news/31000_elderly_homeless.aspx

[6] Overcharging on rent amounts to £60 per week per care home bed. The public funds involved was intended to be used to pay for the care of the elderly in Southern Cross care homes. Instead these funds are being used to pay the interest on £1,100m bonds raised by the QIA when they bought the care home buildings from a private equity company in 2006. Taxes on this income are avoided as the funds are funnelled via companies in the Isle of Man and the Caymen Islands. See www.gmb.org.uk/newsroom/latest_news/31000_elderly_homeless.aspx

- [7] www.bbc.co.uk/blogs/chrisjackson/2010/11/southern_cross_apologises_for.html
- [8] www.cqc.org.uk/newsandevents/pressreleases.cfm?cit_id=37108&FAArea1=customWidgets.content_view_1&usecache=false
- [9] www.gmb.org.uk/newsroom/latest_news/31000_elderly_homeless.aspx
- [10] www.ft.com/cms/s/0/577ab410-f01f-11df-88db-00144feab49a.html#axzz1LKUJmmPD
- [11] www.ft.com/cms/s/0/8d47e0e8-edd8-11df-9612-00144feab49a.html#axzz1LKUJmmPD
- [12] www.corporatewatch.org/?lid=3934
- [13] David Rubenstein, co-founder of The Carlyle Group, www.ft.com/cms/s/0/7e77465e-8616-11db-86d5-0000779e2340.html#axzz1KXki8MqL
- [14] Kavaljit Singh, Taking it Private: the Global Consequences of Private Equity, The Corner House, September 2008, p7
- [15] Investment banks also gained from the exchange, generating \$12.8bn in fees from private equity firms in 2006, whilst utilising securitisation to shift the debt off their balance sheets, recouping the loan quickly and supposedly shifting the risk onto external investors. Kavaljit Singh, Taking it Private: the Global Consequences of Private Equity, The Corner House, September 2008
- [16] *ibid*
- [17] Figure from Dealogic, www.efinancialnews.com/story/2011-04-20/southern-cross-cmg-hgcapital-blackstone?mod=sectionheadlines-AM-PE
- [18] www.businessweek.com/news/2010-11-10/kkr-bain-to-take-third-hca-payout-as-debt-looks-better-than-ipo.html
- [19] www.businessweek.com/news/2010-11-10/kkr-bain-to-take-third-hca-payout-as-debt-looks-better-than-ipo.html
- [20] www.ft.com/cms/s/0/c1350dbc-6917-11e0-9040-00144feab49a.html#axzz1KXki8MqL and www.ft.com/cms/s/0/efb3ae80-4dda-11e0-85e4-00144feab49a.html#axzz1JmzM50LB
- [21] For an example of this argument see Robert Peston's analysis of Marks & Spencer's reaction to buy out attempts in 2003: www.telegraph.co.uk/finance/economics/2783461/Sir-Philip-Green-helped-rescue-Marks-and-Spencer.html

[22] Private equity: history, governance, and operations, Harry Cendrowski, John Wiley and Sons, 2008

[23]

www.guardian.co.uk/society/2000/aug/13/comment.columnists?INTCMP=SRCH

[24] www.guardian.co.uk/business/2009/dec/10/private-equity-profiting-from-debt

[25] www.efinancialnews.com/story/2011-03-11/forbes-billionaires-2011-finance

[26] www.dailymail.co.uk/health/article-1349687/NHS-reform-Cancer-sufferers-given-chemotherapy-Boots-branches.html#ixzz1ByS6Pkom

[27]

www.thenorthernecho.co.uk/news/8964834.Prison_healthcare_jobs_are_at_risk/

[28] see the interview with Dr David Wrigley in this news update for further consequences of this

[29] see, for example: <http://mg.co.za/article/2011-04-29-kidneygate-what-the-netcare-bosses-really-knew>