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REITs Revisited:
Rebutting Misleading and Inaccurate Policy Analysis

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Steward Health Care System has pioneered the creation of accountable care networks nationwide through private funding sources. Steward was the first for-profit healthcare system to use private equity funding (Cerberus) to rescue, reimagine and reinvent a nonprofit health system (Caritas Christi). Steward subsequently became the first health system to use REIT financing (Medical Properties Trust) to fund aggressive expansion of their operating model to new markets.

Caritas Christi was in dire straits at the time of the Steward's $895 million acquisition in November 2010. The Pope reputedly had implored Ascension Health to acquire the beleaguered health system at no cost. Ascension refused as did all other potential nonprofit acquirers.

For these reasons, I find Steward to be a combination of a Horatio Alger story, *Rudy*, and *The Little Engine that Could*, all rolled into one. I wrote about Steward's pluck and big ambitions in a co-authored January 2017 commentary titled, "Letting Go: Steward Sells Its Hospitals and Embraces Patient-Centric Care."

Given my respect for Steward's accomplishments, I feel compelled to respond to Working Paper 189 from the Institute for New Economic Thinking (INET). The INET is a liberal-leaning think tank funded by George Soros.

Rosemary Batt from Cornell University and Eileen Appelbaum from the Center for Economic and Policy Research authored the paper. "The Role of Public REITs in Financialization and Industry Restructuring" has a neutral title, but its editorial stance is anything but balanced.

The authors' analysis centers on nursing homes and hotels, where there is significant REIT asset ownership, but it also includes hospitals where REIT ownership is far more limited. REITs own 197 hospital properties out of a total of 7,201 healthcare properties. REIT-owned hospitals represent only 3% of America's almost 6,000 hospitals.

By law, REITs must be passive investors. Instead, the authors describe REITs as "financial actors that aggressively buy up property assets and manage them to extract wealth at taxpayers' expense." They specifically label healthcare REITs as "Handmaidens of For-profit and Private Equity Owned Operators."

In their skewed analysis of hospital REITs, the authors infer that Steward, Cerberus and Medical Properties Trust (MPT) have grossly misused societal resources. The authors' bias manifests in their reductionist and misguided conclusions regarding REIT funding and healthcare business operations. Their prism is narrow and often self-contradictory. It neglects broader industry trends that shape hospital acquisitions and health systems' strategic positioning.

As a consequence, White Paper 189 overstates the role financing mechanisms play in driving operational outcomes. More importantly, it dramatically understates the role that private-equity-owned operating companies (like Steward was prior to the 2020 physician-led buyout/buyback from Cerberus) play in making strategic acquisitions, redesigning business practices and managing financial risk.

A more balanced assessment would contrast Steward's humble origins against its current and much larger market position when making conclusions about the company's operations, capital structure, community benefit and growth potential.

IN THE BEGINNING…

In 2010, Steward applied funding from the private equity firm Cerberus to acquire the Catholic-sponsored Caritas Christi Health Care, New England's second largest health system. Financial underperformance had placed Caritas Christi at risk of bankruptcy, imperiled jobs and pensions for its 14,000 employees, and threatened to disrupt care delivery in many of Massachusetts' poorest communities.

During the next several years, physician-led Steward stabilized the health system's operations under "Romneycare" (the model for the Affordable Care Act/Obamacare) by becoming a fully integrated accountable care organization (ACO). The company upgraded its facilities, improved its quality, invested in patient-centered technologies and embraced value-based care delivery.

Competing on value as an ACO required a wholesale redesign of physician compensation and the willingness to undertake risk-based contracting. In becoming an ACO, Steward was creating a novel, value-based business-model design to succeed under Romneycare and subsequently Obamacare.

By 2015, Steward had become profitable and Massachusetts' leading provider of community-based healthcare services. The company's cost-effective platform offers competitively priced care services at a significant discount to the state's academic medical centers. This pricing discrepancy has created political tension between Steward and the state's higher-cost health systems. Massachusetts ranks third nationally in per capita healthcare spending.

In 2016, Steward sold its Massachusetts hospitals to MPT for $1.2 billion. It used the funds to retire debt, repay a portion Cerberus' investment and fund capital improvements.

With the Obama Administration's determination to implement ACOs nationwide, Steward was well positioned to expand. Replicating the sale-leaseback structure it used to purchase Steward's real estate assets in Massachusetts, MPT funded hospital acquisitions for Steward in Arizona, Arkansas, Florida, Louisiana, Ohio, Pennsylvania, Texas and Utah.

In the words of its CEO Ralph de la Torre, Steward has become "a glorified managed care" company. It strives for global capitated payments with upside rewards for achieving high-quality outcomes. Empowered primary care physicians "own their patients" and quarterback their care.

Independent physicians are tightly affiliated within the Steward delivery network. They're "more franchise than affiliate." Physicians "play by the rules and focus on total care costs, not maximizing treatment volumes and revenues." While most health systems are asset heavy and burdened by an excessive facility investment, Steward is "asset-light" and built to deliver value-based care.

In 2020, Steward physicians, led by CEO de la Torre, acquired a controlling interest in the company by buying out Cerberus. The physician group now controls 90% of the company. MPT owns the remaining 10%.

According to the Centers for Medicare and Medicaid Services (CMS), Steward is now one of the nation's largest ACOs. In 2021, it generated the second-highest level of savings for Medicare among 513 program participants while achieving a perfect quality score.

Like most growth-oriented companies, Steward experienced operating losses as it moved into new markets. Like almost all hospitals during COVID, Steward has suffered operating losses related to declines in elective procedures. Unlike most health systems, Steward expanded its capacity to care for low-income COVID patients in response to compelling patient and community needs.

Like all large health systems, Steward adjusts its portfolio of facilities and services to market circumstances. What doesn't change is Steward's commitment to appropriate, patient-centered care delivery. As governmental and commercial payers shift to value-based payment models, Steward is well positioned to compete as a high-quality, low-cost provider.

INET WORKING PAPER 189

Batt's and Rosenbaum's working paper reads like a set of conclusions in search of supporting data and analytics. With their belief that the government should eliminate REIT-based tax breaks, the authors support their critique by highlighting the following three "impacts" that negatively affect the U.S. economy. My rebuttal follows each bullet.

- *REITs create tradable assets with no connection to the real purpose of the productive enterprise.*

  Creating tradable assets within liquid markets reduces transaction friction between buyers and sellers. They facilitate exchange, which moves markets toward value. The authors correlate building ownership with corporate mission. Nothing could be further from the truth. Brand and customer experience define market value and positioning. Viewed from this perspective, REITs are just one of many funding mechanisms available to property owners, nothing more or less.

- *REITs play a major role in industry consolidation.*

  In a fragmented industry like healthcare, consolidation is beneficial as long as it promotes efficiency and level-field competition. While the authors appropriately note that healthcare mergers historically have been anticompetitive, REIT financing is not to blame.

  Regional concentration grants some health systems monopoly pricing power. Regional healthcare monopolies are much more prevalent among nonprofit health than for-profit systems. Indeed, for-profit health systems often provide competitive counterweights to high-price nonprofit systems, like Steward does in Massachusetts.

  For-profit and nonprofit are tax designations. Nonprofit and for-profit healthcare companies essentially do the same thing. There is no inherent public advantage to nonprofit ownership. The right way to assess institutions is by the outcomes they deliver, not their tax status.

- *Sale-leaseback provisions place an undue burden on facility operators because of built-in rent escalators and underfunding of capital improvements.*

  While true that automatic rent escalators can cause economic hardship, the REIT structure enables property owners to finance one hundred percent of their assets' value and retain operating control. Onerous escalator clauses that create financial insolvency can ultimately work against the REITs, as evidenced by the significant restructuring activities described in the working paper's case studies on nursing homes.

  Moreover, operating companies can and do apply capital from REIT asset sales to invest in their facilities and operations. Generating returns on REIT-funded investment capital that exceed the incremental cost of rent escalators is the key to long-term financial stability. Consequently, operating companies, like Steward, ultimately control their own destiny. As with all financing mechanisms, REIT funding has defined risk-reward parameters that operating companies accept in pursuit of value creation.

  Importantly, REIT transactions shift facility-ownership risk to REITs from operators. This risk is significant during times of industry disruption with declining asset valuations. Denying market realities, the authors contend that healthcare business-cycle risk is low (it is not) and that prices for healthcare assets are stable (they are not). Moreover, REITs' property-management expertise can improve operating performance. MPT's expertise in energy management through its partnership with CREF, an independent asset-management company, is a great example. With MPT's and CREF's assistance, Steward has saved over $20 million in energy costs and expects to be carbon-neutral by 2030.

Beyond their flawed "impact" reasoning, Batt and Rosenbaum mischaracterize the nature of Steward's healthcare assets; misunderstand the financial motivations of operating companies, PE investors and publicly traded REITs; and overstate the value of REIT-driven tax advantages relative to those accorded nonprofit hospitals.

Steward's Assets: In their overview of the broader REIT market, the authors emphasize the higher "institutional quality" of REIT-owned assets. "REIT-like" assets represent the upper half of all commercial real-estate properties. In the article, a graphic depicts REITs' share of these high-grade assets growing sizably between 1995 and 2021, from roughly 2% to just under 19%.

Since the number of publicly traded REITs has remained relatively constant during this interval, the authors reach the startling conclusion that REITs' dramatic increase in market capitalization during this period (from $58 billion in 1995 to $1.25 trillion in 2020) results from property acquisitions. They neglect entirely increases in owned-property valuations and overall market dynamics, which are major contributors to REITs' increasing market capitalization.

The authors' observation that REITs acquire higher-quality assets runs counter to Steward's hospital acquisitions. For the most part, Steward has acquired underperforming assets in lower-income communities. In funding these acquisitions, Cerberus and MPT placed significant confidence in the ability of Steward's management to improve the performance, quality and profitability of these acquired assets.

This logic seems lost on Batt and Appelbaum. They assert that REITs "team up with private equity firms to strip property assets from healthcare providers." In Steward's case, this conclusion is ludicrous. Steward's assets only have value to the extent that management can improve their operations. There would be no investment return to private equity or REIT owners otherwise.

Financial Motivations: Let's overstate the obvious. PE investors are heat-seeking missiles for profit. They pursue investment returns wherever they can find them. In their most positive manifestation, PE firms invest in companies that can generate outsized returns by transforming operations within inefficient markets.

My co-authored commentary, "Asset Light and Ready," from 2016 discussed this type of transformational investing by PE firms in private physician groups. These physician groups wanted to remain independent while pursuing accountable care delivery. Cerberus' original investment thesis for Steward applied the same logic. Steward needed Cerberus' funding to acquire the Caritas Christi assets. Cerberus needed Steward's vision and operational expertise to generate investment returns.

The Steward-Cerberus relationship was reciprocal, not one-sided. For this reason, I find it particularly galling that Batt and Appelbaum attribute Steward's hospital acquisitions solely to Cerberus. The authors also castigate Cerberus for paying dividends to their investors with their share of the MPT sales proceeds instead of redirecting those monies back into Steward. Can they really be that oblivious? Steward, not Cerberus nor MPT, is the driving force behind the company's investments and performance.

I also risk overstating the obvious in asserting that MPT independently makes its own investment decisions and is accountable to its shareholders for its financial performance. MPT is not a handmaiden to either Cerberus or Steward. Nor, did it team up with Cerberus to strip Steward of its assets. MPT acquired Steward's assets for a negotiated price. It is now working with Steward to optimize the value of those investments.

Tax Treatment: Batt and Appelbaum repeatedly assert that REITs' preferred tax status enables predatory behaviors that extract wealth from taxpayers. Yet, they fail to quantify the societal cost of REIT tax benefits. They also do not quantify the cost to investors of REIT dividends taxed as ordinary income (no capital-gains treatment). This lack of quantification significantly weakens their argument.

Whatever the societal cost of tax benefits for healthcare REITs, that cost stands in stark contrast to the societal cost of hospital tax exemption. Citing research by Johns Hopkins University professor Gerard Anderson, a recent *Wall Street Journal* article pegged the cost of nonprofit hospitals' tax avoidance at greater than $60 billion per year. This is roughly half the $120 billion that the authors cite as the total market capitalization for the 18 publicly traded healthcare REITS.

The $120 billion figure captures the entire value of the 7,290 properties owned by healthcare REITs. As mentioned earlier, only 197 of these properties are hospitals. Relative to the tax benefits consumed annually by nonprofit hospitals, REIT-based tax benefits for their hospital investments is a mere pittance. By contrast, Steward is the largest private, tax-paying hospital operator in the United States and provides high levels of charity care relative to national medians.

CONCLUSION: *REDUCTIO AD ABSURDUM*

The Latin phrase "reductio ad absurdum" literally means "reduction to absurdity." It is a mechanism that partisans use to magnify the strength of their arguments when the evidence supporting those arguments is inconclusive or contradictory. Following this rhetorical practice, authors Batt and Appelbaum draw sweeping conclusions that lack supporting evidence. Here are several examples:

- *REITs bear little risk if an operating company fails.* (Page 6)
- *REIT ownership may be contributing to greater inequality in the U.S. economy.* (Page 7)
- *Healthcare operations are inherently riskier than property ownership of nursing homes and hospitals.* (Page 20)
- *Separating real estate ownership from operations poses serious risks and dangers for patient care.* (Page 23)
- *Who were the winners and losers in these (Steward's) transactions? Clearly patients, healthcare workers, suppliers and communities lost out.* (Page 42)
- *Short cuts in the care of patients increase cash flow in the hands of these Wall Street firms, creating opportunities for extraction of resources by financial agents.* (Page 47)
- *PE ownership of hospital operations combined with REIT ownership of hospital real estate undermines hospital financial stability and patient care.* (Page 47)

Supported by flawed reasoning, the INET's White Paper 189 directly attacks for-profit healthcare operators, PE firms and healthcare REITs. As such, this "academic" paper is actually a political polemic masquerading as in-depth policy analysis. Reading between the lines, the authors support traditional hospital business models, particularly those operated as nonprofit organizations. They believe that incumbents operating under more rigorous top-down regulatory schemes will deliver greater health equity and better health outcomes.

Steward's success in Massachusetts challenges the deeply held belief among some partisans that for-profit healthcare companies cannot offer comparable societal value. Steward delivers higher levels of community benefit than almost all of its non-profit competitors as measured by service prices (lower), quality outcomes (equivalent or higher), consumer satisfaction (higher), charity care (higher) and taxes paid (much higher).

American healthcare is broken. Complex payment formularies riddled with perverse incentives lead to fragmentation, overtreatment and excessive medical error. They also discourage prevention, disease management and health promotion. As currently constituted, the U.S. healthcare system steals resources from the American people, overburdens clinicians with administrivia and harms its consumers. Transforming the nation's bloated and profligate system requires disrupting status-quo business practices.

With the support of private equity and REIT funding, Steward is attempting to create a nationwide, value-based healthcare company that delivers better health outcomes at lower cost with superior customer services. It is a brave but risky proposition. Too many incumbents have vested interests in maintaining the status quo. Working Paper 189 serves their interests.

Here's my conclusion on Working Paper 189: Despite the authors' intention of exposing and reducing the "worrying influence" of REITs on taxpayers and the healthcare markets, their policy prescriptions would stifle innovation, stymie health system transformation and subvert consumer-centric care delivery. Always remember that outcomes matter, customers count and value rules.

AUTHOR

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