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From the Desk of R. Lewis Dark...

THE DARK REPORT

RELIABLE BUSINESS INTELLIGENCE, EXCLUSIVELY FOR MEDICAL LAB CEOs/COOs/CFOs/PATHOLOGISTs

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R. Lewis Dark

Founder & Publisher

Good Market Analysis Leads to Accurate Predictions

HOW MANY OF YOU REMEMBER WHEN, JUST A FEW YEARS AGO, it was **MetPath/Corning Clinical Laboratories** (CCL) which was on the financial ropes? At that time, **SmithKline Beecham, PLC** was expected to be the likely purchaser of CCL.

The date was January 31, 1996. *The Wall Street Journal* reported that **Corning Incorporated**, CCL's parent, "is looking to unload its faltering laboratory division" and mentioned that SmithKline Beecham was talking with Corning to explore the possibility of acquiring CCL.

Obviously that deal never happened, nor did any deal involving any combination of the three blood brothers. Robert Michel, our editor, predicted in THE DARK REPORT of April 29, 1996, that the national laboratory companies would be: 1) forced to take major write-downs; 2) undergo significant restructuring; and 3) there would be no acquisition of one major lab company by another in the immediate future. Rather, a divestiture would be the most likely way that either Corning Clinical Labs or **SmithKline Beecham Clinical Labs** (SBCL) would become uncoupled from its parent corporation.

In that prediction he was prescient. On December 31, 1996, Corning spun off CCL to its shareholders, creating **Quest Diagnostics Incorporated**. In the process, Quest wrote off $445 million of intangibles, in addition to other write-downs at CCL during 1996. On top of past operational charge-offs, **Laboratory Corporation of America** has yet to write down its intangibles. THE DARK REPORT estimated that, in 1997, it would require a $355 million write down to accomplish the job. *(See TDR, April 21, 1997.)* SBCL's write downs were never as large at those at Quest. But it took SmithKline's board three more years to fulfill our editor's prediction of divestiture, as the stories on pages 2-6 demonstrate.

I mention these facts for a reason. Clients and readers of THE DARK REPORT have consistently gotten a more relevant objective analysis about the laboratory marketplace than even financial analysts and reporters from THE WALL STREET JOURNAL. Our discussion of laboratory overcapacity and the destructive pricing strategies for lab testing contracts provides lab executives and pathologists with invaluable management advice. It helps them improve the financial stability and competitive position of their laboratories. It is a major reason why THE DARK REPORT is the trusted information resource for so many lab industry leaders and executives. **TDR**

Quest to Pay $1.27 Billion To Buy SB's Lab Division

Quest's acquisition of SBCL will make it the largest laboratory firm in the world

CEO SUMMARY: Consolidation is the story of the clinical laboratory industry during the 1990s. The decade will close out with the granddaddy laboratory consolidation of them all! When Quest Diagnostics Incorporated completes its acquisition of SmithKline Beecham Clinical Laboratories later this year, it will become a $3 billion laboratory testing behemoth. Expect the merger to also trigger profound change.

ONCE AGAIN, IT'S A CASE OF THE big getting bigger. **Quest Diagnostics Incorporated** will acquire **SmithKline Beecham Clinical Laboratories** (SBCL) in a deal worth $1.27 billion.

The merger, announced February 9, promises to transform Quest Diagnostics into the largest clinical laboratory company in the world, with revenues of $3 billion. The merger will also trigger profound changes to the clinical laboratory industry as we know it today.

"We expect the merger to actually occur sometime in the early summer," said Kenneth W. Freeman, Chairman and CEO at Quest Diagnostics. "Two things must happen first. Regulators need to review the proposed transaction. Also, the transaction will be presented to our shareholders. They must vote to approve the purchase. If everything proceeds as expected, the merger could take place as early as June or July."

Quest Diagnostics will pay $1.025 billion in cash for SBCL. At closing, it will also issue 12.6 million shares in favor of **SmithKline Beecham, PLC**. Valued at $245 million on the day of the announcement, it will give SmithKline a 29.5% stake in Quest Diagnostics. "This makes SmithKline a passive investor in our company," explained Freeman. "They will get two people on our board of directors."

Several aspects of this transaction are noteworthy and should not be overlooked by laboratory execu-

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tives and pathologists seeking to interpret the market signals represented by this transaction.

First, Quest Diagnostics gets a ten-year agreement to provide testing for all of SmithKline's clinical trials. This is a significant plum. Because of the potential of pharmacogenomics to transform diagnostics, the arrangement allows Quest Diagnostics to stay updated about new genetic technologies. *(See TDR, September 8, 1998.)*

Access To Laboratory Data

Second, SmithKline Beecham continues to have access to laboratory data, which is valuable in its pharmaceutical research and development. SmithKline's CEO, Jan Leschly emphasized this point to analysts during the press conference dealing with the SBCL divestiture.

"We retain access to lab data from an enlarged patient data base," he said. "We also retain access to patient data and enhanced formulary opportunities in our sale of **Diversified Pharmaceutical Services** to **Express Scripts**." Leshly's emphasis on these points indicates that SmithKline considers access to data an essential component of its business strategy.

THE DARK REPORT believes these aspects of the transaction validate the importance of laboratory data as the "added-value" linchpin for laboratory services in the future. Both buyer and seller in this transaction want to maintain strong links in each other's information-gathering activities.

Market Forces Drive Deal

Market forces in healthcare are directly behind the decision of SmithKline to divest its laboratory division. *(See sidebar on next page.)* Competition among the three national laboratories and their local competitors has been brutal in recent years.

Quest Diagnostics sees this acquisition as an opportunity to solidify its place as a national provider of laboratory services. "We believe this transaction will make Quest Diagnostics a more successful company," explained Freeman. "Pooling the resources of both laboratory organizations will allow us to enhance services to all levels of customers.

"Patients will see improved access," he noted. "Clinicians will benefit from a fuller menu of lab tests. Clinicians, hospital clients, and managed care companies will have an expanded set of laboratory data with which to work. These are tangible improvements that will result from combining our two companies."

Freeman is correct on these points. Compared to other laboratory organizations in the United States, the post-merger Quest Diagnostics will have a comprehensive network of patient service centers, rapid response labs, courier routes, and regional testing centers. It's national infrastructure will be unmatched by any competing laboratory.

Technology Exchange

In his interview with THE DARK REPORT, Freeman also emphasized the opportunities expected to flow from the ongoing information exchange between buyer and seller. "The world is on the edge of a fundamental change in medical technology," he stated. "Research in a variety of areas moves with ever-increasing speed. All of this will open up new opportunities in diagnostic testing.

"Quest Diagnostics has a right of first refusal with SmithKline for technology which emerges from **diaDexus, LLC**, their research joint venture with **Incyte Pharmaceuticals, Inc.**," explained Freeman. "We hope such access helps us to be first at introducing new diagnostic assays into clinical use.

SmithKline Finally Follows Roche & Corning

By capturing SBCL, Quest Diagnostics becomes the beneficiary of forces long at work inside SmithKline Beecham, PLC. Clients and readers of THE DARK REPORT know we predicted, several years ago, that SmithKline would find itself forced to divest the laboratory division. The reason is simple.

SmithKline Beecham is the eighth-largest pharmaceutical company in the world. During the past four years, its pharmaceutical division and its consumer products division posted revenue and profit gains of 15% to 25% per year.

As a division within SmithKline, SBCL was in a no-win position. Compared to other SmithKline business units, its profit margins were unsatisfactory. Further, because the clinical lab industry is undergoing shrinking utilization and reimbursement, future growth prospects were poor.

Thus, SmithKline Beecham, PLC finally made the decision its two corporate competitors made several years ago: sell the laboratory business.

In 1995, **Roche** spun off **Roche Biomedical Laboratories** when it acquired **National Health Laboratories** and created **Laboratory Corporation of America**. By retaining only 49% of the stock, Roche effectively uncoupled itself from LabCorp's performance. **Corning Incorporated** followed Roche's example. Horrendous financial problems with **MetPath/Corning Clinical Laboratories** (CCL) in 1995 and 1996 forced Corning's hand. They announced in late 1996 that CCL would be spun off to existing shareholders on January 1, 1997. The new company was called Quest Diagnostics Incorporated.

Thus, SmithKline Beecham's decision to divest its laboratory division comes a full two years after those of Roche and Corning. Why it took so long for SmithKline executives to recognize the situation and redeploy those assets is a question that will probably go unanswered.

"If you look broadly across the healthcare marketplace," observed Freeman, "there continues to be consolidation of hospitals, physician groups, and managed care plans. An underlying theme driving these transactions is the need to lower costs while offering an increased level of service.

"We recognize that Quest Diagnostics must do the same thing," he said. "Our interest in SBCL stems from the recognition that every laboratory must master the art of continually shaving costs while simultaneously increasing the value of services it provides. A successful combination of the two laboratory organizations can help us achieve this goal."

Freeman is on target with his succinct description of the healthcare marketplace. It is certainly true that combining the test volumes of Quest Diagnostics and SBCL will provide new opportunities for economies of scale.

But before Quest Diagnostics can harvest those benefits, it must deal with the challenges of pooling two different company cultures, at a time when the healthcare marketplace is undergoing dynamic changes. Other stories in this issue of THE DARK REPORT explore these issues. Quest Diagnostics' acquisition of SBCL will have long-lasting impact on the entire clinical laboratory industry. **TDR**

(For further information, contact Gary Samuels at Quest Diagnostics: 201-383-5000.)

Integrating Quest & SBCL Presents a Big Challenge

It's a daunting task to meld two huge laboratories into one successful company

CEO SUMMARY: Will lessons learned during the commercial lab industry's consolidation frenzy be learned and applied in the Quest-SBCL merger? History has a way of repeating itself. But Quest Diagnostics' CEO has a different plan. He also has a tool not utilized by lab executives earlier this decade—the customer-first management philosophy of "meeting and exceeding customer expectations."

Remember when the lab industry's huge dinosaur labs roamed the country? Like *Tyrannosaurus Rex* in a feeding frenzy, they gobbled up independent labs one after another, dismantling them to feed newly-acquired specimens into their regional testing mother ships.

But the unwritten side to this story was that most acquiring labs lost huge chunks of that acquired business as they dismantled the acquired lab and consolidated those specimens into a distant lab. As clients became alienated, they switched their business to competing labs. This frequently left the acquiring lab with a big purchase cost, and insufficient specimen volume to amortize that purchase.

Lab Industry Pattern

This was a lab industry pattern: lose client accounts whenever local lab sites are closed and testing consolidated into regional centers. For executives at **Quest Diagnostics Incorporated**, this industry pattern will be foremost in their minds as the acquisition of **SmithKline Beecham Clinical Laboratories** proceeds later this year. Combining the two companies without alienating existing clients of both firms will be a major challenge.

For Quest Diagnostics, its acquisition of SBCL is a double-edged sword. After combining the two laboratory companies into a unified operation, Quest Diagnostics will be a formidable competitor in the marketplace. But, the challenges of successfully integrating the two companies will tax the management skills of executives at both companies.

In that regard, Freeman may have an overlooked ace to play. Clients and readers of THE DARK REPORT know that Ken Freeman is not a career laboratorian. He was originally part of the corporate team at **Corning Incorporated**, one of the nation's earliest successful adopters of the quality management philosophy.

In acquiring SBCL, Freeman gains an organization of people already deep in their own quality management phi-

losophy. It is this common ground—quality management—where Freeman has strength from which to build a unified company.

"At Quest Diagnostics, our customer-first philosophy is crafted around the concept that satisfied employees create satisfied customers, and these create satisfied shareholders," said Freeman. "At SmithKline Beecham, they've coined a term, the 'SB Way,' meaning 'simply better,' to describe their customer-focused philosophy."

It is recognized that the most successful companies today are those in which quality management philosophies and principles are deeply imbedded. Quest Diagnostics and SBCL are much further along in that cultural transformation than most other clinical laboratories in the United States.

An Ace To Play

Ken Freeman recognizes that ace card, and intends to play it. "Integrating multiple cultures is always difficult. The fact that both laboratory companies have customer-focused cultures and understand how processes drive the business means we start from common ground.

"SBCL has a justifiable reputation for quality and service," added Freeman. "As operations of the two companies are combined, it is this common management philosophy of focus on the customer which becomes a strength."

Given the size and high visibility of this merger, executives at both laboratories will be challenged to use every advantage to achieve a successful integration. Expect quality management methods to be an essential tool during this process. **TDR**

(For further information, contact Gary Samuels at Quest Diagnostics: 201-383-5000.)

Lab Dinosaurs Became Extinct

Dinosaurs and extinction are good metaphors to describe the fate of the nation's largest laboratory companies of just ten or twelve years ago.

Remember the names: **MetPath**, **Allied**, **Physicians Clinical Labs**, **MetWest**, **Damon**, **International Clinical Labs**, **Nichols Institute**. In their heyday, they dominated the industry landscape.

And where are these powerful monsters of 1988, 1991, and 1994? Extinct! Their genetic descendents live on in the form of **Laboratory Corporation of America**, Quest Diagnostics Incorporated, and SmithKline Beecham Clinical Laboratories.

It was a rapid process which led to the extinction of a thriving industry of independent commercial laboratories. Most industry executives attribute the quick financial reversal of the clinical lab industry to declining reimbursement and punishingly low capitated rates. But there is another market dynamic which was equally responsible, but virtually overlooked.

That market dynamic is the process of laboratory consolidation. When a large laboratory company purchased that small, local laboratory from its pathologist-owners, it seldom handled the acquired business with a high level of success.

As the acquiring lab dismantled its prize and shipped specimens off to a distant lab for testing, it frequently alienated a large segment of the acquired client base. Customers switched to competing labs. Since the purchase price for a lab was based on its existing volume of business, any lost client volumes meant the acquiring laboratory had paid for business which no longer existed. Yet it was still obligated to pay for that lost business!

Successful Laboratories Share Winning Methods

Managers and pathologists from nation's leading laboratories will tell their story in May

CEO SUMMARY: Leading laboratory organizations from three countries will take the podium at the EXECUTIVE WAR COLLEGE in New Orleans on May 11-12, 1999. Their objective: to share up-to-date information on effective laboratory management strategies and methods used to deal with the challenges of managed care, declining reimbursement and healthcare consolidation.

UP-TO-THE-MINUTE DEVELOPMENTS in laboratory and pathology management will be revealed at this year's *EXECUTIVE WAR COLLEGE*, scheduled for May 11-12 at the Sheraton Hotel in New Orleans.

A late addition to the program is **Auckland Healthcare System** (AHS) of Auckland, New Zealand. It's a fascinating management case study. North American laboratorians will find many common themes in how this laboratory is dealing with healthcare changes in its own country.

"We are New Zealand's largest healthcare provider," said Graeme Benny, Ph.D., General Manager of Clinical Support for AHS. "Our lab services group is a major player in New Zealand. It is the largest by revenue and by dollar volume, and has the most extensive test menu in the nation.

"Although New Zealand's entire healthcare system is in turmoil, pathology and laboratory have been particularly hard-hit," continued Dr. Benny. "We are being challenged to run commercially-viable operations in an environment that continues to retain historical revenue protection mechanisms for private providers. Money is incredibly tight and hospitals find themselves providing the 'safety net' for complex, expensive cases while the private segment concentrates in high-volume, low complexity fee-for-service work."

"Although New Zealand's entire healthcare system is in turmoil, pathology and laboratory were hit particularly hard," continued Dr. Benny.

New Zealand's problems are consistent with those in the United States and Canada. Joining Dr. Benny on the podium will be lab executives from **Tenet Healthcare** and **SmithKline Beecham Clinical Laboratories**. They will discuss the regionalization and consolidation project involving 30 Tenet hospital laboratories in Southern California.

Another fascinating presentation will be **Dynacare Kasper Medical**

Laboratories of Edmonton, Alberta. Over a two-year period, the province reduced funding for laboratory services by 30%. In response, all hospital and commercial laboratories were required to come together and create a unified, regional laboratory network.

Slashed Expenses By 40%

Under this common laboratory management umbrella, Edmonton's laboratory administrators were able to slash laboratory expenses by 40%, while preserving a consistent test menu and lab services capability. The experience of Dynacare Kasper Medical Laboratories demonstrates that many laboratories have the potential to achieve much more in productivity and cost reduction than is typical.

"This year's *EXECUTIVE WAR COLLEGE* line-up provides a full range of presentations on the most important subjects challenging laboratory administrators and pathologists," said Robert Michel, Editor-In-Chief of THE DARK REPORT and host of the event. "Attendees will find it to be a management learning lab, an industry 'think tank,' and a powerful networking opportunity.

"We are also excited to be hosting two national laboratory industry firsts," he continued. "One is a nationwide gathering and management-level training for lab and pathology sales and marketing directors. The other is a laboratory CEO SUMMIT day. This invitation-only event will have executive-level briefings from CEOs of several diagnostics industry manufacturers."

In just three years, the *EXECUTIVE WAR COLLEGE* has earned a reputation as a superb place to identify lab industry trends and meet leaders in management innovation. Evidence of this recognition comes from the fact that editors of the major laboratory and pathology publications now consider it a "must-attend" event on their personal calendars.

During the past year, many 1998 *WAR COLLEGE* presentations were profiled in publications such as *CAP Today*, *Clinical Laboratory News*, *MLO*, and others. That further demonstrates that groundbreaking developments in lab and pathology management are recognized first at the *EXECUTIVE WAR COLLEGE!* TDR

(For further information, contact Robert Michel at 503-699-0616.)

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Austin, Texas

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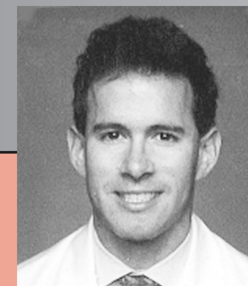
Pathology Consolidation Offers Many Local Benefits

"Business savvy is a precious commodity in pathology. Increasingly it makes the difference between financial success and failure."
Michael Rabin, M.D., Bayless Pathmark Pathology



NEWSMAKER INTERVIEW

Bringing together independent path groups can significantly increase partner's income

CEO SUMMARY: Consolidation of pathology practices can be a complex and drawn-out process. But it doesn't have to be that way. During the 1990s, Bayless Pathmark of Cleveland grew from a two-man practice into a regional pathology resource numbering 22 pathologists and serving 10 hospitals. One surprising result of this process was an increase in partner income. Michael Rabin, M.D., M.B.A. was the architect of Bayless Pathmark's business strategy. In this interview he shares management lessons learned from real-world experience in consolidating pathology practices.

EDITOR: Why does the subject of pathology practice consolidation stimulate heated debate among most pathologists?

DR. RABIN: There's a simple answer and a complicated reason. Simply put, most pathologists don't like radical change, particularly when forced upon them by hospital administrators. But the more involved reason is grounded in what I call the "three Cs:" compensation, control, and comfort.

EDITOR: I understand about compensation and control. When two or more independent pathology practices negotiate their consolidation, control involves who is chosen to be the new leader. Compensation obviously refers to unequal earnings pre-consolidation, and how that issue is resolved during consolidation. But comfort...

DR. RABIN: Comfort has to do with lifestyle. Many pathologists were able to select their own work schedule and days off. They were also able to influence the number of cases assigned to them during the course of a typical work week. So consolidation may require a radical change to the lifestyle patterns of individual pathologists. Not unreasonably, some are reluctant to give that up as part of the consolidation process.

EDITOR: Mike, your "three Cs" metaphor cuts right to the true reason why pathology consolidation is fraught with dissension. A consolidation of pathology practices means you're messing with everyone's money, you might be changing their preferred work schedule, and politics around the choice of new leadership can create factions at odds with each other.

DR. RABIN: That is a reasonable description of why pathology practice consolidation can become emotional, difficult, and impossible to complete.

EDITOR: Which brings me to the reason why I believe you have practical wisdom on pathology practice consolidation to share with clients and readers of THE DARK REPORT. In my visits with pathologists at **Bayless Pathmark**, I've noticed a certain degree of harmony and common purpose lacking in many other large pathology practices. During a ten-year period, you helped a two-man pathology practice expand into a regional pathology powerhouse with 22 pathologists serving ten hospitals. Would you share with us how this was accomplished, and what was done to avoid or minimize the rancor and ill-will so often found in attempts to consolidate pathology practices?

DR. RABIN: That's a tall order. Many of our lessons were learned on a trial and error basis. And we didn't always get it right the first time.

EDITOR: But you seem to have persevered...

DR. RABIN: Yes. Early on we understood that a critical mass of pathologists made sense, both from a clinical perspective and a financial perspective.

EDITOR: Explain that.

DR. RABIN: Two pathologists sitting in a single hospital with one contract are extremely vulnerable to anything the hospital administrators wish to do. More importantly, most small pathology practices fail to manage their business effectively. They work hard, do first-class pathology, and are unaware that they leave huge dollars on their own table every year!

EDITOR: You're describing a conflict between clinical skills and business experience.

DR. RABIN: Basically yes. I'm a physician who also earned an MBA as soon as possible after graduation from medical school. I recognized that medicine was also business. I further recognized that the best medicine is frequently practiced where there is good business support for the group practice.

EDITOR: Why did you get involved in pathology?

DR. RABIN: In 1988 I was retained by a two-man practice at **Meridia Huron Hospital** in Cleveland to trouble-shoot their business practice. After evaluating the situation, I made some basic management and accounting changes. Within 24 months, practice revenue jumped from $600,000 per year to $900,000 per year, without increasing the volume of cases!

EDITOR: This sounds interesting.

DR. RABIN: Yes. It showed me how I could help pathologists focus on their clinical services, while generating more income to the partners.

EDITOR: So this early success probably gave you momentum to pursue additional business initiatives with this pathology practice?

DR. RABIN: That's correct. Different pathologists in the area saw how changing business methods boosted income and improved the working environment for our pathologists. It spurred other practices to investigate what we did.

EDITOR: So tell me what business drivers you utilized to consolidate these other pathology practices into the 22-pathologist organization which created what Bayless Pathmark is today.

DR. RABIN: You can cut our business strategy into two pieces: an internal strategy and an external strategy. The internal strategy meant we focused on existing cases and existing dollars

coming into the practice. How could we organize ourselves differently to capture more net dollars from this specimen flow? What would allow us to increase the partners' income at year-end?

EDITOR: And the external strategy?

DR. RABIN: This was based on offensive and defensive initiatives in the marketplace. Could we diversify revenues by acquiring new client accounts? Could we minimize risk by serving more hospitals. Were there opportunities to hire pathology subspecialists and become the "essential" AP provider in our service area on the eastern side of the Cleveland metropolitan area?

EDITOR: You mean concentrating on selling new business...

DR. RABIN: Yes, but more than that. It is strategic positioning. Could our pathology practice become the major player on our side of town? Could we develop capabilities that made it essential for managed care plans, for IPAs, for hospital provider networks to include us as a contract provider? We had a clear vision of what we had to become to accomplish this.

EDITOR: Is one strategy better or more effective than the other?

DR. RABIN: Truthfully, no. Today's healthcare environment requires every pathology practice to utilize every business tool to its maximize advantage. By accomplishing this, the pathology practice should see improvement in revenue and income, even in coming years. To do less is to court failure.

EDITOR: Those are strong words. So the first advice that you offer is to develop a sound business strategy for your particular market.

DR. RABIN: Yes.

EDITOR: The second piece of advice is that pathologists must simultaneously implement a business plan that addresses "internal" and "external" opportunities.

DR. RABIN: Definitely! Let me give you some specific strategies on the internal approach. First and foremost is what I call the "Revenue Expansion Strategy." We adopted a serious attitude toward charges and collections. It was not uncommon for us to find that most pathology practices tracked individual specimens for liability purposes, but not for financial purposes. Would it surprise you to learn that it was common to find that 30% of the legitimate charges each year went uninvoiced!

EDITOR: Can I assume that, among other reasons, it was because the hospital was billing for the pathologists?

DR. RABIN: Partially true. That is one source of unbilled charges. But even within the pathology practice, services that were provided did not get entered into the billing system. Thus, they were never invoiced.

EDITOR: You've given one example of how much money can be captured. Any others?

DR. RABIN: Well, at consolidation, one practice which joined our group was producing $250,000 per month in revenues. After we implemented our "Revenue Expansion" program, revenue jumped to $350,000 per month. This 40% increase was on the same volume of specimens!

EDITOR: That's an additional $1.2 million per year, and it flows into the practice year after year...

DR. RABIN: Now you understand why we made consolidation a positive event for the practices which joined us over the last ten years. Our business strategy was to show them how they would increase their partner income by consolidating with us, even though they might lose some independence and some flexibility in their personal work schedule.

EDITOR: What else goes into "Revenue Expansion?"

DR. RABIN: We evaluate fee schedules, so that each legitimate charge is billed closer to true market rates. Many labs undercode, lose charges, lose frozens, fail to bill peripheral smears. We capture all legitimate and legal charges previously unbilled.

EDITOR: Other internal strategies?

DR. RABIN: We paid attention to Part A reimbursement by the hospital, knowing that each hospital's stuation is unique. We developed an independent lab to capture Part B fees. But as we did this, we understood that we were entering into a new business and it needed to be managed profitably.

EDITOR: That makes sense.

DR. RABIN: We also reduced business overhead. It shouldn't cost twice as much to manage a million dollar cash flow as a two million dollar cash flow. This makes the economics of consolidation compelling. We incorporated an outside billing vendor into our system. We slashed collection costs while improving the percentage of collected revenue. However, this is not a passive program. We intensely manage this function in partnership with our vendor.

EDITOR: How about operationally?

DR. RABIN: We did the obvious things with buying supplies, etc. Being a larger practice, we acquired productivity tools so the pathologists could do more work with less stress. These included voice recognition systems, which are still under refinement, telepathology equipment, and similar things. We discovered that triaging by specialty is an effective way to boost productivity and revenue. These tools have another important benefit. They enhance turnaround and quality, which gives our pathologists an improved competitive position in the market.

EDITOR: Let's talk about "external" strategies.

DR. RABIN: Well, the defensive tactic should be paramount. When independent hospitals merge, they always discuss downsizing. The pathologist can chose to drive that process or suffer from it. Early on, we decided to be proactive. If there is a single group, covering many hospitals, who cares where the work goes? So we determined that we would serve multiple hospitals and multiple hospital systems. It was a defensive move to diversify our revenue base so we could accommodate the downsizing initiatives that would inevitably occur in our town.

EDITOR: Not many pathologists are willing to acknowledge the reality of that situation.

DR. RABIN: You're right. But our pathologists had the courage to address this on their own. By diversifying revenue sources and by providing partners in the consolidated practice a higher income than they had in independent practice, we gave them an incentive to join us. Our super-practice then became the ultimate income insurance policy which they lacked with their small, independent practice. It also provided them a boost in their personal income. How many pathologists today would appreciate both benefits?

EDITOR: There is a subject I want to discuss in detail with you. It is the marketing and sales of anatomic pathology services.

DR. RABIN: That's an exciting opportunity for pathologists. Done correctly, it's like hitting the revenue jackpot. Unlike small pathology practices, our size provided us with the cash flow to hire a marketing rep and experiment with selling our services to physician offices. The results exceeded our expectations.

EDITOR: But wasn't it difficult to convince the pathologists to invest money in hiring a sales rep?

DR. RABIN: Certainly. Don't underestimate the difficulties our management team had in convincing pathologist partners to invest in many of the business tactics I've discussed. They are a conservative group and like to hang on to the money they've got. It took lots of effort to convince them that investing was good, and would generate increased income for them as the investments matured. Even when we were spectacularly successful in our previous project, asking for more capital to fund the next business initiative was always like pulling teeth.

> ***"It is imperative that pathologists recruit effective business management skills into their practice. It is imperative that they utilize every management tool available to maximize stability and success."***

EDITOR: In that respect, pathologists are their own worst enemy. In today's healthcare environment, it is necessary to invest capital in order to generate more personal income. That innate tendency to stick with the known is why many pathologists find their income eroding, not increasing.

DR. RABIN: Let me give you an example of how we convinced them to fund a sales rep. We had a podiatric pathology practice at one hospital. It was doing about 25 cases per month, 300 per year. That pathologist was eager to get outreach business. So we obtained funding from the partners, hired a *professional, experienced* sales rep (not some rookie at a low salary). Within a year, this sales rep had 250 (and now 500) podiatric cases per month flowing into our practice! With increased revenue flowing into the practice, it was tough for the pathologist partners to continue denying the benefits, and costs, of selling AP services.

EDITOR: Didn't you have similar success selling dermatopathology services?

DR. RABIN: Yes. In fact, Bayless Pathmark aggressively courted and hired a qualified dermatopathologist. He received full partnership at the outset, with built-in performance incentives. If the business grew, he would earn a differential bonus for his specialty.

EDITOR: That's a hefty investment in the future by your pathologists.

DR. RABIN: Yes, because at that time he had only about 4,000 dermpath cases a year. But our pathologists recognized that a good dermpath can generate $1 million per year in revenue. That's double what a typical hospital-based pathologist can generate.

EDITOR: So what happened?

DR. RABIN: Within seven months, our sales rep, working with the new dermpath, increased dermpath cases to 7,000 per year. This, however, was short of our business plan projections. Some partners wanted to pull the plug on the sales rep. She was somewhat brash, and was beginning to earn significant money from commissions.

EDITOR: These pathologists were overlooking the net profit margins she was adding to their pay line?

DR. RABIN: Yes. In fact, we got through that battle and kept her. In another six months, she doubled the number of skins, to 15,000 per year. As partners saw the increase in their year-end distributions, the expense of a sales program ceased to be a concern. In fact, because of our outreach efforts, the overall number of tissues we handle now approaches 90,000 per year. The pathologists' investment in their sales and marketing program has paid big dividends, wouldn't you agree?

EDITOR: Unquestionably.

DR. RABIN: I wish that pathologists would appreciate that one of the strongest tools they can use to preserve and enhance their income is to fund an effective sales program. It is much easier to cover costs and increase partner distributions when net revenue grows year after year.

EDITOR: Are you saying that the "external" strategy should dominate a pathology practice's business thinking?

DR. RABIN: Yes, to the degree that it gets the major emphasis. Remember my earlier comment. It is imperative that pathologists recruit effective business management skills into their practice. It is imperative that they utilize every management tool available to maximize stability and success.

EDITOR: What recommendations do you have for pathologists, given the topics we've discussed today.

DR. RABIN: My themes should be clear. At Bayless Pathmark, we made a commitment to clinical and financial excellence by supporting both. A well-managed pathology practice, by definition, will offer a superior quality of service. It will also provide income stability and growth to its pathologist partners.

EDITOR: That is what you referred to earlier, about the impact of providing useful tools, like voice recognition systems, to help pathologists handle workloads more productively...

DR. RABIN: Precisely! Pathologists should understand that a properly-organized administrative team will make it easier for them to practice a high level of medicine, spend more effective time with clinicians, and generate higher billings for clinical services that are appropriate and add value.

EDITOR: Mike, one single point stands out in this interview. It is the fact that Bayless Pathmark, by its organization and performance in the marketplace, made it a positive event for a smaller practice to consolidate with it.

DR. RABIN: You've hit on the best-kept secret in pathology. When two or more pathology practices consolidate, they should consider it an opportunity to exploit external business strategies, to the mutual benefit of *all* partner's income distributions.

EDITOR: In other words, they'd make more money working together...

DR. RABIN: Certainly. But pathologists tend to focus on what they believe they are giving up by consolidating, not what they can achieve as a combined enterprise. This is one aspect of the Bayless Pathmark story which we did better than our peers.

EDITOR: Mike, we've covered a lot of ground in a short period of time. I am certain that there are more details, and additional business strategies and tactics which went undiscussed.

DR. RABIN: That's true. We've not talked about managed care contracting, hospital system politics, and a host of other significant issues. Bayless Pathmark has its share of victories and defeats with these business activities.

EDITOR: Would you be willing to discuss these subjects with clients of THE DARK REPORT who would like to learn more?

DR. RABIN: Yes. I am interested in learning more about the business strategies of other pathology practices...what's working, what's not. I've done some consultations with a few groups here in the East. Pathologists would be surprised at how easy it is to launch these strategies, once they make that commitment.

EDITOR: Thanks for your insights!

DR. RABIN: Thank you for the opportunity to share the Bayless Pathmark story. It was fun to discuss our experience. TDR

(For further information, contact Michael Rabin, M.D., M.B.A. at 440-449-4717. Email to: mirabin@email.msn.com.)

Lab Industry Briefs

BIO-REFERENCE LABS QUIETLY IMPROVING LAB INFORMATION CAPABILITY

LABORATORY INFORMATION is the strategic business plan driver at **Bio-Reference Laboratories, Inc.** of Elmwood Park, New Jersey. The company has begun to install an information management system throughout its laboratory organization.

"Introducing this software gives us an ideal solution for managing information, i.e., reports, statements, invoices, and any documents that originate as host-generated data," said Mark Grodman, M.D., President and CEO at Bio-Reference.

Dr. Grodman's vision is an integrated hardware/software capability that captures data through scanning and direct entry, then makes it available to any operational process within the laboratory. Internet access by clinicians to their patient's lab data is one goal of this initiative. Bio-Reference Labs is publicly-traded. It reported 1998 revenue of $46 million. It primarily serves the tri-state area of New Jersey, New York and Pennsylvania.

TENET TO SELL UP TO 20 OF ITS 129 HOSPITALS

On February 12, company executives at **Tenet Healthcare Corp.** told financial analysts that it may sell as many as 20 of its 129 hospitals. These would be hospitals which did not fit the company's "major-market" strategy.

Without providing a specific list, Tenet disclosed that it is interested in selling hospitals which fit into two categories: 1) they are not part of a network; or 2) they are not essential to an existing network. It would appear that Tenet is applying the 80/20 Rule (Pareto's Law) to its hospital management strategy. The 80/20 Rule says that, in any distribution of things, a small number (20%) will have a disproportionate impact (80%) on the total.

By corollary, 80% of the distribution has only 20% of the impact. Tenet is apparently interested in selling 20 of the hospitals which fall in this category. These are the hospitals which have virtually little or no impact on the company's major volume of business. By divesting these hospitals, Tenet's management team can spend more time boosting the performance of Tenet's best hospitals. This is good management leadership. It means that Tenet is willing to "cull" those hospitals which contribute little or no profit and absorb disproportional amounts of management time and company resources.

IMPATH'S REVENUES CLIMB 52% IN 1998

DURING 1998, **IMPATH, Inc.** saw revenues and profits grow by 52% and 90%, respectively! It finished the year with $56.3 million in sales and $6.9 million in net income.

Profiled in THE DARK REPORT on February 2, 1999, IMPATH demonstrates how anatomic pathology services, when properly bundled and professionally marketed, represents a booming growth opportunity. The company provides services organized around "difficult to diagnose" cancer. Its primary customers are pathologists working in community hospitals of 100-500 beds. TDR

The Dark Index

Automated Pap Smear Screening Expected to Build Market Share

EXPECT 1999 TO BE A PIVOTAL YEAR in automated Pap smear screening. This new technology is now poised to enter general clinical usage.

As it does, an increasing volume of clinical data will make the case: either automated screening of Pap smears is clinically effective and economically justified—or it is not.

Evidence that automated Pap smear screening is on the increase comes from the year-end financial reports of **NeoPath, Inc.**, based in Redmond, Washington. Revenues for fourth quarter were $2.3 million, of which 65% originated from fee-per-use payments. These are "per click" charges paid by lab customers for each Pap smear run through AutoPap systems located at their laboratories.

Shipping New Systems

NeoPath also disclosed that it had shipped a minimum of 15 AutoPap® units per month during the fourth quarter. Most are heading for **SmithKline Beecham Clinical Laboratories** (SBCL). SBCL is in the midst of a major contract with NeoPath to implement AutoPap screening throughout its national laboratory system. *(See TDR, November 9, 1999.)*

Financial analysts at **SG Cowen Securities Corporation** report that there are now over 70 AutoPap systems at SBCL alone, capable of doing primary screening. They estimate the SBCL units can perform approximately 3 million screens annually, or about 5% of the U.S. market.

These developments in the marketplace are reflected in the changing financial situation at NeoPath. "Our fee-per-use revenue climbed 50% from third quarter to fourth quarter," said Alan Nelson, Ph.D., NeoPath's President and CEO. "This demonstrates that our customers are moving increasing numbers of Pap smears onto our automated screening systems.

"The shipment of 45 new AutoPap systems during fourth quarter is a positive sign," he continued. "As these units enter clinical use, they will generate increased fee-per-use revenue for us in coming quarters.

"Other financial signs are healthy," added Dr. Nelson. "Our costs are down and are declining quarter by quarter. At the same time, our goss margins are increasing. There is improvement in our average per-slide pricing under our fee-per-use contracts. Finally, we are seeing an increase in the number of slides processed per instrument as customers gain experience with their AutoPap systems. These are all positive trends for our company."

THE DARK REPORT continues to believe that various automated cytology technologies entering the marketplace will eventually transform cytology practices. There will be less reliance on manual diagnosis performed at the microscope.

As the sophistication of these technologies improves, cytotechnologists and cytopathologists will become interpreters of increasingly more precise data assessments from test specimens.

This should be seen as a positive development in the science of cytology. Cytotechs and pathologists will discov-

er that their services have greater value to both clinicians and patients. The precision of their diagnostic efforts will generate improved reimbursement from managed care companies.

Clinical Milestones Ahead

That scenario remains in the future. Automated cytology technology is still in its infancy. There are considerable clinical milestones yet to be achieved. However, pathologists and laboratory executives should understand that the clinical capability and the economic justification for today's generation of technology is not constant, but improving.

Specifically, enhancements to computer hardware and video imaging systems will continue to improve the performance of automated cytology systems. This will take place in tandem with forward strides in software algorithms and improved understanding of how these algorithms interact with the range of situations encountered in screening wide segments of the female population.

Free Market Economics

The cytology field is a lesson in free market economics. Companies developing automated cytology systems are motivated by the potential to sell such technology and generate profits. But they can only succeed by demonstrating that such technology truly enhances both the quality of healthcare and the cost of that care.

In that respect, pathologists who track how the market for automated cytology systems evolves are observing a living laboratory, albeit one based as much on economics as on science. That is the new paradigm for healthcare: improved science which improves care at an economically feasible cost.

It should also be noted that NeoPath is not the only company developing automated cytology systems for Pap smear screening. **Neuromedical Systems, Inc.** is repositioning its PapNet® system for FDA approval as an in-lab primary screener. **AutoCyte, Inc.** continues to nurse its Screen™ through the FDA approval process.

Pathologists and lab executives should follow the evolution of these companies and the science they are developing. There will come a time when labs will find it profitable to acquire and offer this technology to clinicians. TDR

(For further information, contact Alan Nelson, Ph.D. at 425-556-2950.)

Reimbursement Evolving for New Pap CPT Codes

Financial analysts at SG Cowen recently commented on the reimbursement situation for new automated pap smear CPT codes which became effective on January 1, 1999.

"On the first of the year," wrote SG Cowen, "NPTH's [NeoPath's] electric [electronic] CPT reimbursement code was established for both the no-review and review population with rates ranging around $12 and $16, respectively. Prior to the first, reimbursement was determined via miscellaneous CPT codes in the $20 range. A more solid rate is expected to be set after 90-120 days in which a trend evolves between the mis-cellaneous and electric [electronic] billing codes. As such, the early trends for reimbursement have been good, in the range of $15-$25 during this "gap fill" period. On the government side, the rate is still $7.15 [for the conventional Pap smear], but HCFA will make a statement in April or May in the Federal Register reevaluating the current status."

Assuming the accuracy of SG Cowen's research, it demonstrates that government and private payers are willing to improve reimbursement as the clinical benefits of automated cytology systems are validated in actual clinical use. This is a good trend for the lab industry.

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Here's more validation that laboratories can use information links to doctors' offices as added value. A recent survey of hospital CIOs was completed by **PriceWaterHouseCoopers**, **Zinn Enterprises** and *Modern Healthcare Weekly*. It revealed that the number one information project was clinical communication infrastructure/ links to clinicians. Over 55% of the hospitals polled were working to achieve this. Laboratories have already mastered the information bridge to physicians' offices. This positions laboratories to be a platform for the hospitals' efforts to move clinical data to clinicians.

Financial progress continues at **PharChem Laboratories, Inc.** in Menlo Park, California. Under the guidance of CEO Joseph Halligan, 1998 revenues at the substance abuse lab climbed 10% over 1997. Net income was $635,000, compared to a net loss in 1997 of $1.27 million. The company's London subsidiary, **Medscreen**, was a strong source of growth. It increased sales by 49% during 1998.

CHICAGO AREA GETS NEW LAB PLAYER

Last Monday a brand new 50,000 square foot laboratory was dedicated by **Alverno Clinical Laboratories** (ACL) in Hammond, Indiana. It's a consolidated laboratory operated by the **Sisters of St. Francis Health Services** and several affiliated hospitals in northeast Illinois and northwest Illinois. James C Sparks, Ph.D. is President and CEO of ACL.

There's a developing story on liquid prep Pap smear technology that bears watching. As more laboratories begin working with liquid prep Pap smears, additional clinical studies are under way. A segment of the cytopathology community believes there is evidence that the performance of liquid prep technology yields mixed results when compared to traditional Pap smear methods. Expect to see some scientific controversy over the effectiveness of liquid prep technology as additional clinical studies are published and debated.

Were you wondering why **Quest Diagnostics Incorporated** was willing to pay the stiff price of $1.025 billion, in cash, and give up almost a third of its equity (another $245 million), to acquire **SmithKline Beecham Clinical Laboratories** (SBCL)? The inside story is that there were multiple bidders for SBCL. Apparently the bidders included **Dynacare, Inc.** of Toronto. Dynacare was able to assemble financing and enter a credible bid for SBCL. It shows both the intent and capability of Dynacare to expand its U.S.-based lab operations. Telephone calls to Dynacare headquarters for confirmation of these facts were not returned as of press time.

Pathologists watching the continuing soap opera known as the physician practice management (PPM) industry will find this to be an interesting postscript. **MedPartners, Inc.** reported its 1998 earnings. On revenues of $2.6 billion, the one-time PPM giant reported a *net loss of $1.26 billion*! MedPartners is exiting the PPM business to concentrate on its Caremark subsidiary. The huge losses relate to write-downs of its PPM operations.

That's all the insider intelligence for this report.
Look for the next briefing on Monday, March 15, 1999

UPCOMING...

- Why Emerging Oncology Technology Will Boost Income for Anatomic Pathologists.
- Follow-Up to Quest & SmithKline: Why Competitors are Ready to "Steal" Accounts
- New Hospital Laboratory Strategies Find Success in the Marketplace.
- Diagnostics Industry Doldrums: How Instrument Manufacturers are Dealing With Laboratory Consolidation and Regionalization.