Volume V, Number 3 Monday, March 2, 1998

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

Consumer Choice Decimates HMO Business Plan

I ENCOURAGE YOU TO CAREFULLY READ THE STORY about the financial woes of managed care plans on pages 13-14. After virtually every big HMO company reported sizeable losses for 1997, **Kaiser Permanente** joined the club with a $270 million loss. Following years of soaring profits, it appears that health insurers are about to enter a sustained phase of financial difficulty.

For commercial laboratories, this is bad news. If managed care plans cannot make a profit, they certainly don't have the cash flow to increase meager reimbursement levels for laboratory testing. For better or worse, the fortunes of clinical laboratories are closely linked to the success or failure of the HMO industry. Clinical laboratory executives already have their own experience with the problems plaguing managed care companies: bidding premiums below actual costs, higher than expected utilization, and inability to accurately collect cost data in a timely fashion (to use in establishing profitable insurance premiums).

But there is an emerging trend now catching managed care plans off guard. Its ramifications are immense. As the number of individuals enrolled in HMOs became a sizeable percentage of the total population, these enrollees began a rebellion against the HMOs' limited choice of hospitals and providers. HMOs are finding that ever-increasing numbers of enrollees are opting for flexible benefit plans which allow them to easily go "outside the network" for care. This increases the medical costs of the typical HMO. One financial analyst described it as "ripping a hole in the organizations' financial projections."

I believe that we are seeing the early stages of a rebellion by insurees and their families. After experiencing strict limitations in their healthcare options caused by rigid HMO rules, many middle Americans now vote with their pocketbook. They chose to pay extra, enroll in a flexible-choice plan, and maximize their ability to go to the doctor of their choice. This is a consumer revolution which is a free-market response to dictatorial, autocratic, and arbitrary managed care plans. Expect to see a similar rebellion in Medicare and Medicare HMOs, particularly as increasing numbers of savvy baby-boomers begin dealing with Medicare's byzantine rules!

These are positive developments for the clinical laboratory industry. Consumer choice will translate into doctors' choice of laboratory provider. The battle for consumer choice is now in its earliest stages. These opening broadsides by the consumer prove that Americans are not to be denied their freedom, even in the choice of healthcare! TDR

1998's Movers & Shakers Go Beyond The Ordinary

Our annual selection of lab industry executives striving to achieve management excellence

By Robert Michel

CEO SUMMARY: As the laboratory industry undergoes fundamental change, new business and management models must be developed. Our list of "Movers and Shakers" for 1998 highlights individuals now leading the science of laboratory management toward these new paradigms.

FINDING EXAMPLES OF LEADERSHIP and innovation among executives and managers within the clinical laboratory industry can be a frustrating task.

After all, times are tough for laboratories. Declining reimbursement weakens the financial performance of most laboratories. Hospital mergers and alliances fuel widespread laboratory downsizing and consolidation. Clinical integration of healthcare requires laboratories to perform tests and report results in different ways.

But times of stress and crises are when people most need the examples provided by leaders and role models. That is one reason why THE DARK REPORT'S annual selection of "Movers & Shakers" attracts so much attention.

For 1998, we've selected five individuals to share honors as "Movers and Shakers" in the laboratory industry. These five individuals share uncommon qualities of innovation and initiative. More importantly, they possess a forward-looking vision, coupled with an uncanny ability to get people to change and move towards the unknown.

Whether in an academic or clinical setting, our five selectees use sophisticated leadership and management skills to nurture change and create common purpose. Consequently, their laboratory organizations can be considered top performers.

Leadership and management skills are essential to success in any organization. The clinical laboratory industry is no different. Those laboratories which did well in 1997 have a higher caliber of executive leadership than their competitors. As the growth of managed healthcare places a premium on business man-

THE DARK REPORT Intelligence Briefings for Laboratory CEOs, COOs, CFOs, and Pathologists are sent 17 times per year by The Dark Group, Inc., 1731 Woodland Terrace Center, Lake Oswego, Oregon 97034, Voice 1.800.560.6363, Fax 503.699.0969.

R. Lewis Dark, Founder & Publisher. Robert L. Michel, Editor.

SUBSCRIPTION TO THE DARK REPORT INTELLIGENCE SERVICE, which includes THE DARK REPORT plus timely briefings and private teleconferences, is $10.80 per week in the US, $11.40 per week in Canada, $12.45 per week elsewhere (billed semi-annually).

agement skills, laboratories with sophisticated leadership will be better positioned to succeed and prosper.

In choosing these five people as 1998's "Movers & Shakers," the goal was to identify individuals whose established track record indicates they will continue guiding their respective laboratory organizations towards progressive new ways of providing medical tests.

Making such choices is never easy. To aid the process, the list was restricted in two ways. First, it was limited to executives who directly work in either an academic or clinical laboratory environment. Second, it excluded executives employed by laboratory vendors, such as instrument manufacturers and LIS companies. In these cases, the quality of the product is often integral to the success of the executive.

These five individuals share several common traits. They are passionate about their vision. They communicate that vision effectively to co-workers and others. They go outside the laboratory industry to find solutions to their problems. They use sophisticated management tools to implement necessary changes in their laboratory organizations. Undoubtedly there are others who deserve to be recognized as laboratory "Movers & Shakers." THE DARK REPORT encourages clients and readers to contact us with information about such individuals.

As was true of our selectees from earlier years, expect to hear more about these five people and their laboratory organizations during 1998 and beyond. Reaction by the marketplace to their innovations will provide invaluable knowledge for the entire clinical laboratory industry.

This is vitally important. Current market trends will continue to transform traditional laboratory organizations. New paths blazed by these laboratory leaders and innovators will point our industry toward the best business ideas for restoring stability and prosperity.

Bill Hagestrom

Chief Executive Officer
UroCor, Inc.
Oklahoma City, Oklahoma

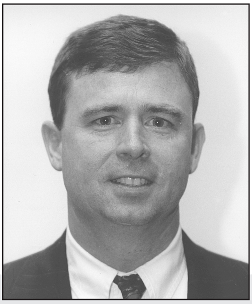
HERE IS A UNIQUE STORY for a company built around diagnostics. When Bill Hagestrom was hired to be President of **UroCor, Inc.** (known then as **CytoDiagnostics, Inc.**), it was entering Chapter 11 bankruptcy. The year was 1990.

Revenues at the beleaguered company were $1 million per year. Hagestrom studied the market for diagnostic services. He decided that the company should make urologists its primary customer.

Energized by Hagestrom's vision and focus, the company incorporated a "close to the customer" philosophy and was off to the races. In each of the four years from 1993 to 1996, UroCor earned a place on *Inc. Magazine's* "500 Fastest-Growing Companies" list.

For 1997, revenues topped $33 million. Now a public company, UroCor is profitable and rapidly evolving. Originally the company offered diagnostic testing services to urologists. Now it markets a growing array of sophisticated disease management products as well as business services tailored to the needs of urologists.

UroCor's physician clients respect it for technology, quality and advanced services. Investors respect it for its management track record. Both are testimonials to Bill Hagestrom's leadership.



Jack Finn

Chief Executive Officer
Centrex Clinical Laboratories
New Hartford, New York

BUILDING A HOSPITAL-BASED laboratory into a regional laboratory powerhouse is what brought Jack Finn to the attention of THE DARK REPORT.

Finn is Chief Executive Officer of **Centrex Clinical Laboratories**, headquartered in New Hartford, New York. Centrex is a consolidated laboratory organization serving three hospitals and two independent labs. It maintains a thriving outreach program and is actively recruiting additional hospital partners to join the Centrex consortium.

Finn was the executive who founded the regional laboratory organization back in the late 1980s. Centrex grew in steps, with the addition of new hospital participants. An aggressive laboratory outreach program has fed increasing volumes of specimens into the core laboratory. A network of phlebotomy sites and rapid response labs supports Centrex's outreach program.

Regular expansion of testing volume from both inpatient and physician office sources made it possible for Centrex to actually decrease the average cost per test it offers participating hospitals over a multi-year period. Finn's strategic vision and ability to build effective coalitions are two of the qualities which helped Centrex emerge as a dominant competitor.

Michael Becich, M.D., Ph.D.

Director, Pathology Informatics
University of Pittsburgh Medical Center
Pittsburgh, Pennsylvania

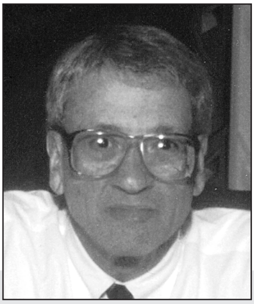
WORKING IN ACADEMICS does not prevent Dr. Michael Becich from exercising entrepreneurial skills. His passion is adapting information technology for application in anatomic pathology.

To that end, Dr. Becich is pushing pathology's boundaries with his attempts to create a "virtual pathology practice." His vision involves the transmission of pathology data using the internet and other electronic pathways.

For the past two years, Dr. Becich has hosted a symposium in Pittsburgh titled *Anatomic Pathology Informatics, Imaging, and the Internet* (www.pathology.pitt.edu.apiii97). Held in October, the meeting attracts an international crowd.

Given the rapid development of computer hardware, software and imaging technology, each generation of Dr. Becich's "virtual pathology laboratory" comes closer to meeting the needs of both pathologists and the clinicians they serve.

Dr. Becich is the nexus for those within pathology who want to push boundaries and expand clinical services through information and imaging technology. His entrepreneurship and initiative attract similar-minded pathologists world-wide. That is why one should look to Pittsburgh for one vision of pathology's future.



Michael Snyder, M.D.

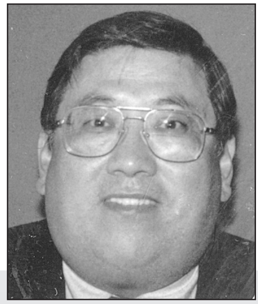
Director, Clinical Labs & Pathology
UMASS Health Systems Laboratories
Worcester, Massachusetts

CAN AN ACADEMIC HOSPITAL become nimble enough to operate a profitable laboratory outreach program?

For **UMASS Health Systems Laboratories**, the answer is yes. Dr. Michael Snyder's story is unusual. Here's a laboratory administrator who quietly "bootlegged" his laboratory outreach program into the marketplace.

After several years, the increased specimen volume had used up excess capacity within the laboratory. Significant increases in laboratory outreach revenue and operating profits convinced hospital administration to authorize additional laboratory FTEs. They also formally organized the laboratory into a for-profit division to give it flexibility and responsiveness to marketplace needs.

Dr. Snyder's experience demonstrates that remarkable changes can occur even in environments that tend to stifle innovation and change. In the case of UMASS Labs, Dr. Snyder developed a way to sell the intrinsic strengths of the academic and tertiary center hospital. He did this while bypassing cultural roadblocks against change common to such institutions. The momentum of the laboratory outreach program was sustained in steady growth.



Charles J. Miller

COO & Executive Director
Peconic Regional Laboratories
Riverhead, New York

AFTER DEBATING THE MERITS of a consolidated laboratory organization, three Long Island hospitals decided it was time to act. To expedite the project's implementation, Charles Miller was recruited last April to finish due diligence, create the business plan, and get things into operation.

Since then, the fur's been flying on the east end of Long Island. **Peconic Regional Laboratories** (**Central Suffolk**, **Eastern Long Island**, and **Southampton Hospitals**) is on the fast track. Phase one strategy is shared services. To that end, 40% of send-out testing generated by the three hospitals was quickly internalized. A standardization program was finished and implementation is under way.

As the development work for the consolidated laboratory organization proceeds, existing laboratory outreach sales activity continues. Southampton Hospital saw its outreach program grow 10% during 1997, despite the inroads of managed care and a rather mature market environment.

Those working with Miller find his energy and enthusiasm infectious. He is gaining respect as a laboratory leader who can change the status quo for the better. Future successes at Peconoic Regional Laboratories should demonstrate how leadership makes a difference in laboratory performance.

1997's "Movers & Shakers" Maintain Pace Of Excellence

What happened to them during the previous year?

David Beckwith, Ph.D.
VP & Clinical Director,
Health Network Laboratories,
Allentown, PA.

Dr. Beckwith is implementing total laboratory automation (TLA) in his core lab using the "island archipelago" concept. He is scheduled to present the experience of this project at the *Executive War College* in New Orleans on May 12-13, 1998.

Richard Brooks
Chief Financial Officer,
Physician Clinical Laboratories,
Sacramento, CA.

Although Brooks surprised financial analysts with his efforts to stave off the inevitable, problems at this troubled lab finally took it into Chapter 11 bankruptcy. New ownership brought in a new management team and Brooks left PCL and the laboratory industry to take another position.

Robert Hamon
Director of Laboratory Services,
Presbyterian Laboratory Services,
Charlotte, NC.

During 1997, construction was begun on a new core laboratory of 54,000 square feet. Presbyterian's parent healthcare system also merged with another system. Hamon is now dealing with the consequences of the merger as it affects laboratory operations in both systems.

Robin Felder, Ph.D.
Professor of Pathology and Director,
Medical Automation Research Center,
University of Virginia Hospital,
Charlottesville, VA.

Dr. Felder's January, 1998 Total Laboratory Automation conference in San Diego was successful, drawing automation experts worldwide. His research center continues to push automation technology forward.

James Neeley, M.D.
Principal,
Incline Software,
Cupertino, CA.

Dr. Neeley now operates his own consulting firm, offering laboratory automation design and engineering services. He has already helped a major manufacturer create automated instrument modules using his technology and design philosophy.

Ken Freeman
Chief Executive Officer,
Quest Diagnostics Incorporated,
Teterboro, NJ.

Quest Diagnostics made great strides in 1997. But Freeman's challenge in restoring a $1.6 billion national laboratory to robust financial health remains daunting. To that end, a major restructuring of the national laboratory system at Quest Diagnostics is under way.

Bruce Friedman, M.D.
Director,
Pathology/Ancillary Data Systems,
University of Michigan, Ann Arbor, MI.

Expect innovative developments at Dr. Friedman's annual May conference in Ann Arbor, Michigan on laboratory information systems. He's assembling a cracker-jack program based on cutting-edge technology in new software and hardware applications.

Louis D. Wright, Jr., M.D.
Chairman,
Pathology Service Associates,
Florence, SC.

In 1996, Dr. Wright helped launch the first state-wide pathology network, located in South Carolina. Since then, PSA has morphed into a national "association" of state pathology networks, with activities under way in NC, SC, FL, TN, GA, CA, and WA.

DIANON Systems Acquires Pathology Lab In Florida

Company's action intensifies competition for pathology business in the Sunshine State

CEO SUMMARY: Another national pathology player is betting on Florida. DIANON Systems, Inc.'s purchase of a local pathology laboratory raises the competitive bar in Florida. With AmeriPath and Pathology Service Associates already gearing up to battle for market share, DIANON's local presence brings a savvy competitor closer to the battleground.

FLORIDA IS ABOUT TO BECOME a major battleground for anatomic pathology services. Three pathology powerhouses are preparing to contest each other for increased market share.

DIANON Systems, Inc. served notice that it will be a combatant. The company, based in Stratford, Connecticut, acquired **Pathologists Reference Laboratory** (PRL) of Tampa in January.

> ***"DIANON Systems intends to be a value consolidator. Florida is the perfect market to unify anatomic pathology services and offer them in a uniform package."***
>
> ***Jim Barry***
>
> *VP, Marketing & Technology Development*
> *Integrated Healthcare Solutions*

PRL is a significant pathology provider in the Tampa market. Comprised of five pathologists, it performs 40,000 surgical pathology cases and 200,000 cytology evaluations every year.

Because DIANON Systems has traditionally operated a centralized pathology laboratory, purchase of a Florida pathology practice surprised many observers. It is the first evidence that DIANON Systems intends to expand into local markets.

"Yes," responded Jim Barry, Vice President, Integrated Healthcare Solutions at DIANON Systems, "purchasing PRL represents one phase of our business plan for 'consolidating' pathology services within DIANON Systems.

"We use the term 'consolidate' in a specific sense," he continued. "Internally, we consolidated pathology services by funneling large specimen volumes through our central laboratory. This gave us leverage to improve quality, consistency and productivity among our 28 pathologists. Our sophisticated reports and information services play a key role in the consistent growth of our anatomic pathology business."

"Externally, we would like to provide the same services to other pathology groups," noted Bill McDowell, Director of Pathology Development. "DIANON wants to offer value-added anatomic pathology services which are consistent to all our clients, physicians and managed care plans, regardless of their location within the United States."

Timing of DIANON Systems' purchase in Tampa is not coincidental. It has to to with the potential size of Florida's market for anatomic pathology services. "Florida tops our list of geographical areas we consider critical to our growth plans," explained McDowell. "It has a large population and a high proportion of Medicare patients. Demographic trends will cause the number of Medicare patients in Florida to increase rapidly as baby-boomers age."

Managed Care Penetration

"Florida also has a high penetration of managed care," noted Barry, "although not as high as California. PRL gives DIANON a local pathology presence. It allows DIANON to compete in Florida for two reasons.

"First, we are physically close to surgicenters and other sources of AP specimens in that market. We want to provide physicians in Florida with the ability to use our programs while sending to a local pathologist," said Barry. "Second, a few of the managed care plans in that state want a provider to have local presence. PRL allows us to attain provider status for those managed care plans."

Intense Competition

Barry's comments demonstrate how intense the competition for anatomic pathology specimens in Florida has already become. For many years DIANON Systems maintained six to seven sales representatives in the state. But that is no longer enough. A physical presence allows DIANON Systems to be more competitive with other pathology companies.

DIANON Systems' acquisition of Pathologist's Reference Laboratory demonstrates that the company is responding to changes to Florida's anatomic pathology marketplace. Expect to see further acquisitions, but only in key markets where DIANON Systems needs a local presence to compliment its central pathology laboratory in Stratford, Connecticut.

From a competitive market perspective, DIANON Systems' acquisition of PRL is a definitive statement that the company is ready to commit substantial sales resources into protecting and enhancing its existing market share of anatomic pathology in Florida. TDR

(For further information, contact Jim Barry at 203-381-4000.)

DIANON Generates More Revenue In '97

During 1997, DIANON Systems, Inc. increased revenues 8.7%, from $56 million to $60.9 million. Net income jumped 52%, from $2.2 million to $3.3 million.

Long considered an innovator in clinical pathology and diagnostic testing, DIANON Systems has quietly shifted emphasis towards anatomic pathology. This segment of the company's business grew 19% from 1996. Besides urology, DIANON Systems is offering specialized services in dermatopathology, gastroenterology, and cervical pathology.

A simple concept encouraged DIANON Systems to build up anatomic pathology. "Competition is intense in clinical pathology and laboratory testing," stated Jim Barry, VP, Marketing and Technology Development. "It was four years ago that we recognized the relative lack of competition for a national provider of anatomic pathology testing, combined with the opportunity to provide added value."

Pathology Competitors Make Florida The Target

Hospital-based pathologists should prepare for the impending, intense marketing blitz

CEO SUMMARY: Florida is about to become the marketing battleground for anatomic pathology. Three well-funded players are preparing to launch major sales efforts. Pathologists in the state wait with trepidation. Expectations of discounted pricing and a "gloves-off" sales strategy concern Florida's hospital-based pathologists.

FOR PATHOLOGISTS CONCERNED with their economic and professional future, Florida is a state to be watched. Three well-financed companies are gearing up aggressive sales programs to capture additional anatomic pathology business.

New clients seized by these companies will come at the expense of local pathologists in the state. In particular, established clients of hospital-based pathologists will be solicited by these sales programs.

Leading the pack is **AmeriPath, Inc.** The company, based in Riviera Beach, is flush with cash from a public offering and has a big credit line with major banks. During the past several months, it ran advertisements in the help wanted sections of local newspapers and lab industry publications for sales reps and marketing managers.

Next in the competitive line-up is **Pathology Services Associates of Florida** (PSAF). This is a regional network of pathology practices organized last year under the business model developed by Dr. Louis Wright, Jr. of Florence, South Carolina. Like AmeriPath, PSAF is preparing to field a Florida-based sales force.

Also in the game is **DIANON Systems, Inc.** of Stratford, Connecticut. DIANON already has sales reps in Florida calling on prospective accounts. Its acquisition of **Pathologist Reference Laboratories** in Tampa earlier this year was a strategic move to expand its presence in the Sunshine State. *(See pages 7-8)*.

New clients seized by these companies will come at the expense of local pathologists in the state. In particular, established clients of hospital-based pathologists will be solicited by these sales programs.

A careful assessment of the business dynamics currently under way leads THE DARK REPORT to conclude that Florida will soon become the radical business battleground for pathology in exactly the same way that California became the radical business battleground for clinical laboratories.

In California, managed care's rapid introduction caused the intensely competitive laboratory market to cut its throat while fighting for business. Numerous bankruptcies and radical downsizing throughout the state astonished laboratory executives everywhere.

Increase Specimen Volumes

Pathology will soon undergo a similar scenario in Florida. Each pathology company intends to blitz the state with an aggressive sales program. All three companies have the same goal: to increase the volume of anatomic specimens flowing into their laboratory.

This heightened sales activity promises to radically shift historical relationships between established pathology practices, their clients, and the hospitals they serve. Pathologists in Florida already see intense marketing fights over anatomic pathology specimens coming from surgicenters and other non-hospital sources.

But the impending sales campaign will introduce a new twist into the war: hospital contracts. For the first time in any pathology marketplace, we predict Florida hospital administrators will soon be regularly visited by sales representatives from pathology companies.

Lower AP Prices Ahead

These sales reps will begin the process of getting hospital administrators to consider the benefits of switching their anatomic pathology work. THE DARK REPORT believes that most sales people will offer a primary benefit to hospital administrators: lower price for anatomic pathology procedures.

It doesn't take a crystal ball to foretell this. Sales people take the path of least resistance and "lowest price" is the easiest way to capture new accounts. This is particularly true of sales people whose commissions are thin because they've failed to bring in new business.

Whether these pathology sales reps successfully get the AP business or not, hospital administrators will use these "low price" business proposals against the pathology group which holds the existing contract for that hospital. Such proposals become negotiating levers against their current pathology group at the next contract renewal talks. This is the reason why the impending pathology sales blitz in Florida will beat down the overall reimbursement level for anatomic pathology services.

What is particularly interesting about the coming sales blitz is that all three companies represent a different business model for pathology. AmeriPath is a publicly traded physician practice management (PPM) company. Its pathologists are employees. AmeriPath wants to develop the capability of providing pathology services throughout the United States.

Physician Network Model

Pathology Service Associates of Florida is organized as a statewide component of a national network organization of PSA pathologists. It wants to preserve pathology at the point of care while providing the business structure to allow local pathologists to participate in state, regional, or national pathology contracts. Those practices currently a member of PSA organized themselves in order to access the anatomic pathology business negotiated through larger regional and national contracts Because PSA is composed of hospital-based pathologists, it will not send sales reps to solicit hospital AP contracts.

DIANON Systems is entirely different than AmeriPath or PSAF. It is a national reference laboratory with a central laboratory in Connecticut. Historically, it fed AP specimens into its central laboratory. The recent acquisition of a pathology laboratory in Tampa is a new twist on that strategy.

With three vastly different business models, the coming sales war in Florida will provide a great deal of useful information on which type of pathology

Pathology Sales Wars Wounded One Florida Pathology Practice

FOR EVERY ACTION, THERE IS A REACTION. When **AmeriPath** issued a press release in 1997 announcing its agreement to provide expanded AP services in Florida to **SmithKline Beecham Clinical Laboratories** (SBCL), it was a winner in the bid process.

But there was also a loser. It was the pathology practice which lost that anatomic pathology contract. For **Pathologists Reference Laboratory** (PRL) of Tampa, the contract represented a significant volume of total work flow. Lost revenue from that contract compounded the general decline in reimbursement experienced by pathology groups throughout Florida.

All parties with direct knowledge of this situation declined to talk on the record. It appears that additional financial pressure resulting from the lost contract played a role in the decision by PRL's owners to sell the laboratory. As reported in this issue, DIANON Systems Inc. was the eventual buyer.

This situation is instructive. It demonstrates how rapidly the financial position of an established pathology practice can erode when just a few key contracts or clients are lost. This lesson should not be overlooked or ignored by pathologists, particularly in Florida.

Is AmeriPath the good guy or the bad guy in this story? The answer is neither. AmeriPath is a creature shaped by the stock market. Investors and shareholders want a return on their money. They expect revenues and operating profits to grow by 8%, 10%, !5% or more each year. If shareholders don't get this growth, they replace management.

That is why AmeriPath has a huge appetite for growth. It is not sufficient to grow by acquisition alone. AmeriPath must also increase the annual revenues at each pathology practice which it buys. Failure to do so might cause shareholders to replace management. That is why the gloves are off in the next round of marketing wars. It is survival of the fittest.

Pathologists in Florida and other states should wake up to the new reality: the collegial days of respect and friendly competition among local pathologists are over. By the end of 1998, Florida will be a battlefield littered with the debris by more than one pathology practice which failed to respond to the impending sales onslaught and was forced to sell or merge to competitors.

organization can best survive in a managed care environment.

But it is also important that pathologists in Florida and elsewhere understand the ramifications of this impending sales battle. For the first time in history, sales forces will be diligently calling on *any* source of anatomic pathology specimens to capture the business for their pathology organization. It means that no longstanding pathologist-client relationship can be taken for granted.

Those pathologists who wake up to this fact have the best chance of countering these trends and stabilizing their income. Despite competition, there are opportunities to maintain strong client relationships and bring added value to physicians. But the "sit and wait" strategy will no longer work. Pathologists should educate their colleagues to the threat. The time has come for definitive action. TDR

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

Kaiser Reports Huge Loss, Many HMOs Losing Money

A variety of intractable problems cause more than half of health insurers to bleed red ink

CEO SUMMARY: Poor financial performance of many managed care plans is bad news for clinical laboratories. Those insurance plans losing money find it tough to increase reimbursement for laboratory tests. Financial struggles of the health insurance industry should be closely watched for its impact upon physicians, hospitals and laboratories.

TURNABOUT IS FAIR PLAY. After reporting years of fat profits, HMOs and the large health insurers are now posting sizeable losses. At least half of the major HMOs reported losing money in 1997.

As these companies reported their year-end earnings, the biggest surprise came from **Kaiser Permanente**. The managed care giant reported a loss of $270 million for 1997 on revenues of $14.5 billion. In 1996, Kaiser earned profits of $265 million.

The loss was the first ever reported by Kaiser. Collectively, sizeable losses at Kaiser, **Oxford Health Plans**, **PacifiCare Systems**, and **Aetna/US Healthcare** demonstrate the severe troubles now faced by the healthcare insurance industry.

Financial analysts see no quick way for the HMOs to fix these problems. Many analysts predict several more years of financial turmoil before the industry regains profitability. If true, rough times lie ahead for clinical laboratories. Unprofitable HMOs will find it difficult to be generous in their reimbursements for laboratory testing.

Financial woes of the managed care plans come at a bad time for clinical laboratories. In many instances during the last year, contract renewal negotiations between laboratories and managed care plans led to higher reimbursement. Anecdotal evidence of this trend was reaching THE DARK REPORT with increasing frequency.

Common Problems

Kaiser's problems are common to those of other troubled HMOs. During the course of 1997, Kaiser increased membership 19%, to 8.97 million. But three things caused the oldest "managed care" organization in the United States to lose money. First, the company offered employers low premium rates to attract new accounts. Kaiser had aggressive goals for increasing membership. But these low premiums failed to cover the cost of servicing the new members.

Second, Kaiser's members traditionally use the company's "in-house" services. But large numbers of new enrollees, particularly in California, meant Kaiser had to let those members go outside the system for care. Kaiser says that up to $180 million of non-network care resulted from this phenomena.

Third, the rate of increase in medical costs exceeded Kaiser's expectations. Matched against low premiums, this acerbated the resulting losses.

Similar Experiences

All three problems should be familiar to clinical laboratories. In the early years of managed care, laboratories underwent similar experiences in discounted pricing, leakage of tests, and increased costs.

One comment by a managed care expert will ring true to laboratory executives. Uwe Rheinhardt is a health-economics professor at **Princeton University**. He defines the financial strategies of managed care plans as "less than brilliant."

"They [managed care plans] have been going for market share, feeling that they need to be big," noted Rheinhardt. "They compete to see who can offer the lowest premiums, to the point that the marketing people set the rates and the actuaries are sent out of the room. They they pray to God and their medical directors that they can keep expenses low."

Applies To Laboratories

Rheinhardt's observations might apply to a number of laboratories, both national and regional. In the first years after 1990 sales and marketing people were frequently allowed to offer money-losing capitated rates, despite the protests of financial officers who knew the true cost of testing.

Clinical laboratories then entered a period, starting around 1993-94, where the disastrous financial consequences of offering money-losing capitated rates become obvious. Since then, the commercial laboratory segment of the industry has struggled to regain satisfactory profit margins. This market phase is entering its fifth year.

That is why THE DARK REPORT considers it critical that laboratory executives understand the serious consequences to their own finances if it develops that HMOs have entered a similar period of sustained financial losses.

Payment for laboratory services comes primarily from two sources: Medicare/Medicaid (the government) and private insurance plans. Certainly the government is not in a position to generously increase existing reimbursement levels for laboratory testing in coming years. That leaves private insurance plans. But if industry losses continue over the next two to five years, then laboratory testing reimbursement levels will suffer.

Two Compelling Facts

THE DARK REPORT offers two compelling facts that will retard the HMOs' ability to reverse financial losses in coming years. First, they can only set prices one time per year. If they underprice premiums, they must wait one year before they can come back and make up that mistake.

Second, the HMOs' information systems still offer incomplete and "late" data on utilization and costs. Thus, each time they sit down to calculate premiums, their analysis of costs during the immediate past period may understate actual costs by a significant amount.

Combine these two business problems, and you can understand why it may take the HMO industry several years to regain an equitable balance between actual costs and premium income.

One other factor will retard this effort. Even when an HMO establishes a rigorously accurate cost analysis, the marketplace will limit the amount of cost increases it can push along to employers. If they need a 16% price increase to regain profitability, will employers accept that? Or will employers resist "exorbitant" price increases and switch to competing plans? TDR

(For further information, contact THE DARK REPORT at 800-560-6363.)

Catholic Healthcare West, Tenet Form Joint Venture

Not-for-profit system partners with for-profit firm to create a 7-hospital healthcare system

CEO SUMMARY: This consolidation initiative brings together the resources of both hospital operators. The objective of the partnership is to more efficiently align services in California's San Joaquin Valley. This is a proactive step that anticipates further reductions in reimbursement and inpatient admissions in California's competitive environment.

BY POOLING RESOURCES in California's Northern San Joaquin Valley, **Catholic Healthcare West** (CHW) and **Tenet Healthcare Corporation** are creating a new business model for hospital integration.

The announcement, made last month, brings together five hospitals owned by a not-for-profit hospital system, Catholic Healthcare West, with two hospitals owned by Tenet, a for-profit hospital firm. The partnership will operate under the name **Central Valley Healthcare System LLC**.

Unlikely Partnership

The unlikely partnership between not-for-profit and for-profit organizations illustrates a key theme emphasized by THE DARK REPORT: regionalization of clinical services. The motive of both partners is to align their existing service infrastructure so as to meet the rapidly evolving needs of managed healthcare in the region.

It is a 50-50 partnership and will not require the exchange of assets or merger of any facilities. The goal of the partnership is to create a delivery network that improves the combined system's ability to enter managed care contracts which cover the service area.

The partnership intends to accomplish this by integrating services. It will offer increased access points in several counties, serving a population of 1.5 million people. Because information is an essential part of a managed care system, both partners intend to share data and experiences.

Effectively, the partnership creates a power base in the area south of Sacramento. It is a strategic business move to make it more difficult for major integrated healthcare systems in Sacramento to expand into the home turf of CHW and Tenet.

Hospital laboratory administrators should understand the consequences of this partnership between CHW and Tenet. It is a new business model which will be closely watched by the hospital industry. If the partnership proves successful, expect to see similar partnerships between for-profit and not-for-profit hospital organizations.

What drives this deal, and others to follow, is the need to regionalize clinical services, reduce overcapacity, and eliminate redundant clinical resources. The fact that it occurred first in California validates the perception that managed

Partnership Is Offensive Market Strategy

Combining forces in the market area south of Sacramento allows both Catholic Healthcare West and Tenet to forestall expansion by healthcare systems and managed care plans based in Sacramento.

Facility	Location	Beds
St. Joseph's Medical Center	Stockton	327
St. Joseph's Behavioral Health	Stockton	35
St. Dominic's Hospital	Manteca	63
Mark Twain St. Joseph's Hospital	San Andreas	48
Mercy Hospital & Health Services	Merced	101
Doctors Medical Center	Modesto	397
Doctors Hospital	Manteca	73

care in the state is forcing healthcare providers to consider every option for lowering cost, improving clinical services and offering regional coverage.

This should sound familiar to hospital laboratory administrators. These are identical economic reasons that support the formation of regional laboratory networks. It also is a wake-up call. If regionalization of clinical services is going to occur, why should laboratory directors and administrators at individual hospital laboratories delay organizing some form of regional laboratory services?

As this partnership between CHW and Tenet becomes operational, expect to see regionalization and consolidation occur to the laboratories at the seven participating hospitals. The economic benefits of consolidating laboratory services are too great to be ignored. Thus, consolidation will occur relatively quickly.

Because of the newness of this partnership, operational details have yet to be addressed by either company. CHW is the majority partner, so it will direct much of the planning effort. For these reasons, a number of months will pass before any plans involving laboratory regionalization are drawn up.

Unprecedented Partnership

However, such plans will happen. Assuming that this unprecedented partnership moves forward, at some future date laboratory services will be consolidated to eliminate redundancy and to create a regional system.

Keep in mind the element which makes this partnership notable. It is a venture between a not-for-profit hospital organization and a for-profit hospital corporation. Expect to see more of these types of arrangements. It is cost reduction and regionalization which justifies their creation. TDR

For further information, contact Catholic Healthcare West at 209-467-6314.

Lab Industry Briefs

AMERIPATH REPORTS EARNINGS, NEW PURCHASE

AmeriPath, Inc. of Riviera Beach, Florida announced its 1997 financial performance. For the year, company revenues totaled $108.4 million.

On February 17, the company also disclosed the acquisition of **Anatomic Pathology Associates** (APA), located in Indianapolis, Indiana. AmeriPath intends to combine APA's 14 pathologists with the 13 pathologists of **CoLab**, its original pathology acquisition in Indianapolis. APA serves seven hospitals and generates about $6 million in annual revenues.

The addition of APA gives AmeriPath 18 physician practices in eight states. The company employs 144 pathologists. As a pathology-based physician practice management (PPM) company, AmeriPath's business plan calls for continued acquisition of pathology practices. *(See related stories, pages 7-11.)*

SMITHKLINE/GLAXO DEAL OFF, BUT MAY NOT BE OVER

Both **SmithKline Beecham PLC** and **Glaxo Wellcome** made announcements that merger talks between the two companies had ceased. A variety of issues caused the two companies to disagree on how to proceed.

Since that announcement, securities analysts have stated that they feel SmithKline Beecham is still interested in pursuing a strategic merger or acquisition. Additional speculation by financial experts in New York and London indicate that Glaxo might possibly launch a hostile take-over bid for SmithKline. Both scenarios probably mean that SmithKline remains "in play."

In the meantime, SmithKline Beecham released an abbreviated earnings statement. For 1997, sales of pharmaceuticals were up 7%, consumer product sales increased by 11%, and sales at the clinical laboratory division were up 6%. Given the poor reimbursement situation for laboratory tests, that is a respectable showing for the laboratory division.

UNILAB CORPORATION MAKES MONEY IN 1997

California-based **Unilab Corporation** made a profit in 1997. The company reported revenues of $214.0 million, an increase of 4.3% over 1993. Net income was $0.5 million for the year.

Given that Unilab posted a $92.9 million loss for 1996, the turnaround in 1997 represents a major accomplishment for the beleaguered laboratory. In fact, Unilab's EBIDTA (earnings before interest, depreciation, taxes and acquisition) for the fourth quarter was a company-record $6.6 million (12.5% of sales). EBIDTA is an important measure of cash flow. At Unilab, EBITDA increased in each of the four previous quarters.

Were Unilab to continue demonstrating strong cash flow numbers during the first half of 1998, such performance might be evidence that the company has successfully restructured itself to meet the needs of California's managed care marketplace. If so, that may be an early sign that there is a profitable combination of operations and laboratory services which a clinical laboratory can sustain within California.

IMPATH, INC. PLANS TO SELL MORE STOCK

Disease management is proving to be good business for **IMPATH, Inc.** of

New York City. During February, the company reported a strong financial performance in 1997. IMPATH followed the earnings release with an announcement that it would sell an additional two million shares of stock.

IMPATH is one of a select number of diagnostic companies which is focusing on disease management services. IMPATH offers cancer information and diagnostics to clinicians and pathologists throughout the United States. It has developed a data base of 300,000 analyzed cases.

For 1997, IMPATH generated revenues of $37 million. This is a 69% increase from 1996 revenues of $22 million. Net income almost doubled, increasing from $2.0 million in 1996 to $3.79 million in 1997.

IMPATH has facilities in New York, Los Angeles and Arizona. It provides "patient-specific cancer diagnostic, prognostic and treatment information to more than 4,000 physicians specializing in the treatment of cancer patients, in over 1,650 hospitals and 140 oncologist practices."

IMPATH and **UroCor, Inc**. of Oklahoma City are two of the earliest companies organized exclusively to adapt diagnostic testing technology to create disease management products.

PRUDENTIAL HEALTHCARE GRANTS SOLE-SOURCE CONTRACT TO SMITHKLINE

Capping a multi-year process of RFPs and negotiations with the three blood brothers, **Prudential Healthcare** finally announced that **SmithKline Beecham Clinical Laboratories** would be its sole-source laboratory provider.

Three categories of Prudential health plans will be served by SBCL under this agreement: Prudential Health Maintenance Organization, Point of Service, and Administrative Services Only plans. A majority of Prudential's 4.8 million managed care members are enrolled in these categories of plans.

Those knowledgeable with Prudential's RFP process say that Prudential considered a variety of laboratory provider arrangements, including multiple laboratory provider panels. They indicate that SBCL's goal was to negotiate a sole-source agreement similar to the one they signed with **Cigna** in 1995. For that reason, SBCL offered Prudential a comprehensive menu of laboratory services and pricing which, in the end encouraged Prudential to opt for a sole-source laboratory arrangement.

LABONE POSTS LOSS FOR 1997 DESPITE RAPID REVENUE GROWTH

Lab*One*, Inc. announced its 1997 financial performance. Due to a $6.6 million write-off from the anticipated sale of its existing laboratory facility the company reported a net loss of $2.4 million.

However, that write down masks a strong year for the Lenexa, Kansas-based laboratory. Revenue in 1997 increased 33%, from $59.4 million in 1996 to $78.9 in 1997.

Growth was balanced in all three divisions within Lab*One*. Revenue from clinical laboratory testing increased 91%. Substance abuse testing revenues climbed 101%, while life insurance testing revenues grew 22%.

The company's LabCard laboratory benefits program continues to grow. Currently it serves 1.8 million members, with another 300,000 lives awaiting implementation. The balanced growth at Lab*One* demonstrates that a professional sales program directed at niche markets can build a sizeable revenue base of profitable business. **TDR**

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

An interesting executive shuffle is under way at **Quest Diagnostics Incorporated**. James D. Chambers was promoted to Senior Vice President, Marketing and Business Development. He will report directly to CEO Ken Freeman. Chambers will assume many of the duties handled by Don Hardison, Jr., who is leaving Quest Diagnostics.

ADD TO:...QUEST
Chambers has a non-laboratory background. Before joining Quest Diagnostics in 1993, he was with Corning Incorporated. Hardison was formerly with **SmithKline Beecham Clinical Laboratories** (SBCL). He was recruited by Quest Diagnostics in early 1996, around the time that SmithKline reorganized certain of its healthcare services divisions.

Cigna Corp. and a Brazilian partner are investing $200 million in Gold Cross, a large healthcare company in Brazil. Gold Cross insures 1.5 million HMO members and other insurance customers. Cigna had earlier invested in another Sao Paulo-based HMO that serves 500,000 members. Look for more international investments by American insurance companies and health care providers.

ADDITIONAL CRIMINAL CHARGES UPCOMING

Assistant U.S. Attorney Kathleen Haley told a federal judge in Fort Meyers, Florida that another indictment is coming in the government's investigation into **Columbia/HCA Healthcare Corp.** She also stated that additional charges would be brought against Columbia managers Robert Whiteside, Michael Neeb and Jay Jarrell. All three executives are currently awaiting trial under earlier indictments. It was not disclosed who the additional defendant would be, nor what specific charges would be filed against that individual.

MORE ON:...CRIMINAL INDICTMENTS
Even as the government continues its investigation of Columbia/HCA, the so-called "Lab Scam" probe of clinical laboratories continues. The latest round is criminal indictments filed against four former executives of **Damon Clinical Laboratories, Inc.** in Boston. Named in the January 22 indictment were Joseph Isola, formerly President; Beno Kon, formerly corporate controller; William Thurston, formerly Senior Vice President, Operations; and Gerald Cullen, formerly Senior Vice President, Operations. They are accused of conspiracy to defraud the MediCare program of more than $25 million.

ADD TO:..."LAB SCAM"
Purchased by **MetPath, Inc.** (now Quest Diagnostics Incorporated) in 1994, Damon pled guilty to federal charges and paid $119 million in civil and criminal penalties in 1996. These new indictments by federal prosecutors indicate that "Lab Scam" is still an ongoing federal project. In fact, the original 1993 subpoena against **Nichols Institute** remains unsettled. MetPath purchased Nichols in 1994 and has a reserve of $70 million to cover potential penalties related to that subpeona.

That's all the insider intelligence for this report.
Look for the next briefing on Monday, March 23, 1998

THE DARK REPORT

UPCOMING...

- Laboratory Benefits Programs Come Of Age.
- First Criminal Indictments Of Laboratory Executives Since 1992 Cause For Concern.
- Winning Sales Strategies For Hospital Laboratory Outreach Programs.
- Diagnostics Manufacturers Meet Managed Care Challenges With New Ways To Acquire Instruments, Reagents, And Consumables.