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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

Restricted information, see page 2

Commentary & Opinion by...

R. Lewis Dark

Founder & Publisher

Integrity Remains a Valued Business Asset

LATELY I SEEM TO BE LIVING UP TO MY ROLE as the "crusty curmudgeon." The opinions and commentaries I contributed to these pages in recent issues of THE DARK REPORT triggered a considerable number of letters and feedback from our clients and regular readers.

In particular, my observations about "Why There's Bad Blood Against the National Labs" in the January 20th issue seemed to resonate with a great number of our readers. Among my comments was an anecdote about the lack of professional cooperation among two competing labs in a Southern city. The point was to illustrate why many in the laboratory profession hold the nation's largest public lab companies in such low esteem. Too often, it is the public lab companies' own actions and decisions in the marketplace which put them at odds with their professional colleagues.

But why did my observations trigger so much feedback from our readers? More than a few chose to respond. We heard numerous examples of egregious behavior in their city by laboratory competitors. We also heard plenty from laboratorians who wanted to tell us that they are disappointed that some of the nation's most influential laboratory organizations have been co-opted by the need to deliver earnings and profits to Wall Street.

In sifting through these comments, I spotted a common theme: integrity! At the heart of each response was a sense that some of our industry-leading enterprises have lost moral fiber. The drive to boost profits was encouraging expedience. Too often, the consequences of decisions by a few ended by adversely affecting the entire laboratory profession.

I found it refreshing to learn that so many of our laboratory leaders remain committed to integrity in all levels of business and personal life. At a time when our religious institutions are under siege and traditional values are ridiculed, it is inspiring to hear from lab executives and pathologists who believe it is possible to build a profitable lab business without sacrificing integrity.

More importantly, I suggest that the need for integrity has never disappeared. In the daily decisions each of us make about which company's product or service to buy, trust and integrity continue to play a key role. That is particularly true of the lab industry, where patients and physicians alike place a life-or-death trust in the integrity of our laboratory test results. TDR

Buyout of AmeriPath Riles Some Shareholders

Dispute over proposed sale to Welsh Carson provides an inside peek into the deal structure

CEO SUMMARY: Owners of the few remaining independent private laboratory companies closely watch prices paid by lab buyers. In the pending sale of AmeriPath to private equity investor Welsh, Carson, Anderson, & Stowe, dissenting shareholders disclosed several aspects of the valuation process. This information provides useful insights into the process of valuing laboratory companies.

DISSENTING SHAREHOLDERS ARE unlikely to change the outcome of the announced acquisition of **AmeriPath, Inc.** by **Welsh, Carson, Anderson, & Stowe**, a private equity investment company based in New York City.

Announced on December 9, the transaction is moving forward. Welsh Carson offered $21.25 per share, which was a 30% premium over AmeriPath's closing price of $16.45 on the previous business day.

At least one group of shareholders filed suit against AmeriPath seeking a court injunction to prevent the sale. Another dissident shareholder objecting to the sale was **MMI Investments**, which beneficially holds 4.5% of AmeriPath stock. MMI raised several objections to the sale, including poor timing, potential conflicts of interest by officer/directors, and a rather low sales price based on several different ways of valuing the company.

Because of its large size and activities in hospital-based pathology services, AmeriPath has become a bellwether company—one which is closely watched for clues as to how the anatomic pathology marketplace is evolving. THE DARK REPORT can identify three categories of pathologists directly affected by AmeriPath's business activities.

First are the 400+ pathologists employed at AmeriPath. They not only rely on AmeriPath for income, but hold modest amounts of stock in the company.

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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 $11.90 per week in the US, $12.50 per week in Canada, $13.55 per week elsewhere (billed semi-annually).

Second are pathologist-partners in private group practices. Because AmeriPath is an active buyer of pathology group practices, pathologists interested in selling their group want a financially-flush AmeriPath capable of paying top dollar. But AmeriPath also represents a competitive threat to local pathologists. In certain cities where AmeriPath owns a group, it competes directly against other pathology groups in that region.

Guidance About Lab Values

The third group is laboratory owners. For them, how AmeriPath itself is valued by its current buyers provides guidance about what knowledgeable buyers are willing to pay to acquire laboratories.

In criticizing the proposed buyout of AmeriPath by Welsh Carson, dissident shareholders opened the door to aspects of laboratory acquisitions not normally made public. As professional investors with sizeable holdings of AmeriPath stock, they believe AmeriPath is selling at the wrong time, and for too cheap a price.

Their first criticism is that the timing of AmeriPath's sale to Welsh Carson stinks. MMI stated "this is a management buy-out that has been pre-arranged with extraordinary barriers to competitive bidding in order to ensure a low price from shareholders for management's enrichment."

12-Day Sale Window

First was the decision to limit offers from other buyers to a 12-day period. MMI noted that a 12-day window makes it extraordinarily difficult for other potential buyers to arrange financing and express interest.

Next, MMI pointed out that AmeriPath entered into this sales agreement at a time when both **Quest Diagnostics Incorporated** and **Laboratory Corporation of America** are preoccupied with significant acquisitions of their own (**Unilab** and **DIANON Systems**, respectively). Thus, neither national lab company would be expected to be an aggressive bidder, if at all.

This is highly relevant reason because everyone involved in this sale—both within AmeriPath and Welsh Carson—earnestly expect that one of the two blood brothers is likely to bid a hefty price for AmeriPath sometime in the next three to five years.

Another significant objection by dissenting shareholders involves the price at which AmeriPath's board has agreed to sell. MMI argues two credible points. One, AmeriPath's sales price is too low and comes at a time when AmeriPath's share price is down for factors unrelated to its core business fundamentals. MMI believes waiting another 12 to 24 months for additional growth would support a higher price at that time.

Low Price For AmeriPath

Second, the sales price for AmeriPath is too low when compared to existing Wall Street numbers for public laboratory companies. Specifically, MMI observes that, "at 6.7 times and 11.7 times Street Consensus 2003 EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) and EPS (Earnings per share), the valuation for this deal is a discount of 26% and 37% of EBITDA and P/E trading multiples of AmeriPath's publicly-traded comparables. This deal is even a 20%+ discount to AmeriPath's own trading multiples from just six months ago. The entire lab sector, but AmeriPath in particular, is experiencing a wholesale multiple compression—why sell now?"

In fact, MMI provides its own estimate of AmeriPath's value should be within 18-24 months. "Using conservative assumptions, many from our discussions with [AmeriPath] management,

our discounted cash flow models indicate an implied value of $31 to $46 [per share] using **J.P. Morgan's** assumptions about the fairness opinion for DIANON Systems [in its sale to LabCorp]."

Of course, arguments about future value must be weighed against today's reality. At the time AmeriPath entered this sales agreement, its stock was trading at $16.45 per share. Welsh Carson is paying a 30% premium over that market price.

...certain shareholder groups, after doing their own financial analysis, have reason to believe that AmeriPath is being sold too cheap.

However, it should also be noted that certain shareholder groups, after doing their own financial analysis, have reason to believe that AmeriPath is being sold too cheap at a poor time in the economic cycle. If one accepts that assumption, the next question is why?

A potential answer can be found by identifying which parties stand to benefit financially by putting AmeriPath up for sale at this time. It is recognized that AmeriPath's senior executive team will get financial incentives linked to the change of ownership, including the acceleration of certain stock options.

For example, James C. New, AmeriPath's Chairman of the Board and CEO, will receive two times the sum of his annual base salary and bonus. Under his current employment agreement, New's current annual base salary is $475,000, and he is eligible to receive an annual bonus potentially equal to 50% of his base salary. When the sale closes, New may be paid as much as $1.5 million.

He currently holds 126,418 shares of AmeriPath stock, only .44% of AmeriPath's 29 million outstanding shares. But after Welsh Carson buys the company, New will be granted options equal to 5% of the new company's stock. Dissident shareholders say that stake could be worth as much as $50 million to New should the company be sold in the next five years.

In fact, post-acquisition, the existing AmeriPath executive team and Welsh Carson will have stock options equal to as much as 12% of the company's total shares. By comparison, currently the executives and directors, as a group, only hold 1.3% of AmeriPath's stock.

For Welsh Carson, if it is buying AmeriPath at a low price, it stands to make significant profits. MMI calculates that "if the AmeriPath transaction is consummated at $21.25, Welsh Carson would be able to flip AmeriPath within three years at a multiple between their purchase price and that of comparable [lab company] transactions—potentially generating an internal rate of return (IRR) of 70%."

Value is the key issue raised by all dissenting shareholder groups. The AmeriPath board commissioned **Salomon Smith Barney** (SSB) to study the marketplace and provide an opinion of fairness. SSB looked at market values using six different comparative methods.

Fairness Opinion On Value

Salomon Smith Barney concluded that, in each method, the low-end "implied per share equity reference range for AmeriPath" was in the range of $18 and $21. On the high end, it was $28 to $33. Dissident shareholders point out that Welsh Carson is paying only $21.25 per share, a low price relative to the fairness opinion of SSB.

All of this information and criticism supports several conclusions. First, Welsh Carson is acquiring Ameripath with the intent to operate it as a short-term owner. It plans to exit

this investment in one of two options. One option is to sell it outright. As noted earlier, two likely buyers are considered to be Quest Diagnostics and LabCorp. The second option is to sell stock to the public, thus providing the liquid market necessary for Welsh Carson to sell its shares at a profit.

Maximize Value

Second, as a "short-term owner," Welsh Carson will be operating the business in ways that maximize its value to some future buyer. In particular, it will probably invest additional money to acquire more pathology group practices.

Third, the need to show steady growth in revenues and net profits means that AmeriPath will probably intensify its sales and marketing efforts against local pathology group practices. A professionally-managed sales and marketing program can generate solid gains in specimen volumes and revenues. That will help Welsh Carson dress up AmeriPath for its eventual sale.

Lots of Speculation

Within the anatomic pathology community, there has always been speculation about AmeriPath. Will it succeed? Will pathologists want to sell their practices? Will they be content to practice pathology as employees of AmeriPath and not as partners in their own group? Is AmeriPath going to compete for hospital contracts in cities where it owns a pathology group?

Since it became a public company in 1997, AmeriPath has demonstrated staying power. It outlasted all other companies that attempted to build a pathology PPM. Six years later, it now does business in at least 20 states and generates almost one half billion dollars per year in revenues. By those measures, it is successful, even if it hasn't revolutionized the business of anatomic pathology...yet! TDR

Understanding Why Quest and LabCorp Can Pay Big Bucks

IN RECENT YEARS, both Quest Diagnostics Incorporated and Laboratory Corporation of America paid strong prices to acquire laboratory companies.

Some lab directors and pathologists have wondered how the acquirers could afford to pay so much money for existing laboratory companies—which may not have been overly profitable at the time of acquisition. The AmeriPath deal provides an opportunity to look at deal-making math.

In criticizing the proposed Welsh Carson purchase of AmeriPath, dissenting shareholder MMI Investments provided its own analysis of various valuation approaches. MMI states "using the same assumptions as research analyst Bill Bonello of **Wachovia Securities**, (an all-cash transaction with interest at 5.0% and tax at 4.0%), we find that a transaction expected to be breakeven to Quest and LabCorp in 2003 would command a deal price [for AmeriPath] above $56 per share and be accretive to Quest's projected 2004 EPS by 4.2% and LabCorp's by 5.5%.

"If the [AmeriPath] deal were struck at $30 per share by these two strategic buyers in order to outbid financial sponsors, we would expect it to be 6.5% and 9.4% accretive to Quest in 2003 and 2004, and 8.2% and 12.3% accretive to LabCorp in 2003 and 2004—all without revenue or cost synergies!" concluded MMI.

It is MMI's assessment that Quest and LabCorp could pay between $30 and $56 per share for AmeriPath as it exists today, and generate ample returns from that investment. This illustrates why the two blood brothers are considered potential buyers of Ameripath at some time in the next few years.

"Where's The Beef?" AP's AWOL at AmeriPath

All the fuss over AmeriPath's sales price overshadows anatomic pathology services

CEO SUMMARY: Certainly AmeriPath has demonstrated strong growth in revenues and earnings since it went public in 1997. But it's a company that "can't get no respect" from Wall Street. Because it was founded to be a physician practice management company (PPM) at a time when such companies were falling out of favor, it has always struggled to develop a more credible identity in the marketplace.

By Robert L. Michel

REMEMBER THAT FAMOUS TELEVISION commercial from **Wendy's** burger restaurants? The elderly lady scrutinizes a big hamburger bun that's obviously short on meat and asks the seminal question "Where's the beef?"

In 1984, it was a catch line that captured the American imagination and was repeated everywhere. More than 19 years have passed and people continue to recall it with ease. This was an advertising success of the highest order. That's because "where's the beef?" cuts to the essential consumer desire: am I getting my money's worth from this company?

In studying the unfolding events at **AmeriPath, Inc.** and its pending sale to **Welsh, Carson, Anderson, & Stowe**, there's a critical element—"the beef,"—missing. In all the documents discussing the sale released by all parties and interested observers, I find little mention of how the delivery of anatomic pathology services will be improved to the benefit of physicians and patients—and thereby to the benefit of employees and shareholders.

Imagine! A sophisticated private investment firm is about to pay almost $840 million to purchase a company that offers anatomic pathology (AP) services to its customers—and nowhere is there recognition and discussion about how the sale may affect or benefit this company's core service.

Focus On Finances

There is certainly plenty of discussion about the valuation of the business, how the proceeds will be distributed to shareholders, and the organizational strategy for the company post-sale. But forgive me for saying this—it seems that "AP is AWOL at AmeriPath." Like Wendy's actress Clara Peller and her "Where's the beef?", I think it is appropriate to ask "Where's the AP?"

Not only do the acquisition documents and discussions seem to overlook how anatomic pathology services will be affected, improved, expanded, or supplemented, but another key asset of this company seems invisible.

Just as there is little ink devoted to anatomic pathology services, it is difficult to find any mention of the 400 anatomic pathologists and dermatopathologists employed at AmeriPath. How will they fare from this acquisition? Does the post-merger plan include elements that incentivize them and align them with strategic objectives such as higher quality medicine, improved cash flow, and expanded clinical services?

AmeriPath is *the* big dog in the anatomic pathology community. It employs 400 pathologists, operates 40 independent hospitals, provides AP services to 200 hospitals, and generated revenues of $478.8 million in 2002. Because of its large size, what happens at AmeriPath has impact on the entire anatomic pathology profession.

Large Case Volume

Because of these facts, AmeriPath has become a trend-setter in its own fashion. With such a large volume of cases, its decisions on test menus, informatics systems, and pricing cause ripples that rock pathology practices in many regions.

So what happens at AmeriPath does matter to the pathology profession. Will its new owners, soon to assume positions on its Board of Directors, bring a newly-intensified focus to core anatomic pathology services? Given the history of the company, that is unlikely.

Remember that AmeriPath was originally designed to be a physician practice management (PPM) company. To build revenues, it would acquire independent pathology group practices. From that revenue base, its value-added contribution is, in theory, to bring sophisticated management, professional sales and marketing, and other business resources to the individual group practices it acquires. The PPM model declares that the business parent brings management expertise to the practice, allowing the physician to concentrate on medicine. Both benefit from this division of labor.

As a PPM, however, AmeriPath launched with a unique difference. Unlike the other PPMs of the day, AmeriPath set out to employ its physicians, not share equity with them.

Away From PPM Concept

Since the well-publicized collapse of the PPM industry in 1998-99, AmeriPath has worked steadily to reposition itself away from the PPM business concept. The company's press releases now describe it as "a leading national provider of cancer diagnostics, genomics, and related information services."

But it cannot shake its roots. As a PPM, most of AmeriPath's value-added comes from accounting constructs, not because it provides a superior menu of anatomic pathology tests and services to its customers that are better than local pathology groups in regions where it competes.

Most pathologists do not understand the accounting principles which AmeriPath uses to create value. The formula is basic and simple. Accounting rules allow AmeriPath to buy a pathology group practice at, say, six times the group's annual net cash flow. It can then write off the goodwill (excess of purchase price over assets) by as much as 40 years.

Within the acquired group, pathologist-partners now become AmeriPath employees. They are paid a salary which is lower than their former share of the annual distributed profits. This arrangement allows AmeriPath to show an accounting "profit" annually from the acquired group's revenues. The combined costs of the goodwill it depreciates and the group's salaries and expenses are less than the pre-acquisition partner profit shares and expenses.

If AmeriPath, in its PPM role, does nothing else at this group practice, the accounting constructs allow it to book a profit. It is important to understand this accounting concept. It is the reason why AmeriPath pays a high-end market price for a pathology group and still shows a year-end profit on operations. Essentially, nothing has changed in the pathology group's annual net revenues, but the pathologists have a big pile of money from the sale and AmeriPath has net cash flow it can declare to its investors.

I believe it is important for pathologists to grasp this essential point: AmeriPath was not founded to bring a better business model to the healthcare community, it was founded to take advantage of accounting constructs which allow it to buy pathology group assets and create "profit flow" that benefits the company immediately.

It's the difference between the business model Michael Dell created with **Dell Computers**, now a $34 billion dollar enterprise, or Fred Smith with **Federal Express**. These individuals created value by bringing consumers a new, different, and/or better service than existed before.

The laboratory world saw a new, added-value business model when Albert E. Nichols, M.D. created the Nichols Institute back in 1973.

The laboratory world saw a new, added-value business model when Albert E. Nichols, M.D. created the **Nichols Institute** back in 1973. Its unique value-added proposition to customers was to bring cutting edge diagnostic technology to clinicians, backed by academic experts who supported the tests they had developed.

By 1990, Nichols Institute was a $280 million public company. The value of this new business model was validated as a host of other esoteric reference laboratories copied Dr. Nichols' business model and entered the marketplace.

In contrast to the business models of Dell, Federal Express, and Nichols, AmeriPath organized to take advantage of accounting principles. These principles allow it to buy an asset—a pathology group practice—at a premium market price, and immediately book a profit without further redeployment of that pathology group's business resources.

Reason To Sell

I would suggest that one important reason AmeriPath's directors feel the need to sell at this time is that, after six years in the business, they have not quite delivered the value-added to their individual group practices which meet customer needs in a way that gives AmeriPath unquestioned competitive advantage over other pathology service providers. Because it was unable to generate higher levels of additional value from the resources (assets) of the groups it acquired, AmeriPath's profit margins have disappointed its investors.

This conclusion is supported by a look at AmeriPath's most recent balance sheet, dated December 31, 2002. On assets of $708 million, it is operating with free cash of less than $1 million. Having minimal amounts of cash constrains management's strategic options and is probably one reason why a sale is being conducted at this time.

This brings me full circle and back to my opening point. "Where's the AP?" For any company to enjoy robust success in the anatomic pathology field, it must provide compelling added-value to referring physicians and patients. AmeriPath has yet to find that winning formula that allows it to evolve away from its PPM roots to become a unique added-value source of pathology services. TDR

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Lab Industry Briefs

PATHOLOGY GROUP IN SALT LAKE CITY BECOMES PSA MEMBER

UTAH IS THE NEWEST STATE to have a pathology group practice become part of **Pathology Service Associates, LLC** (PSA).

Based in Salt Lake City, **Utah Pathology Services, Inc.** is the first PSA-affiliated practice in that state. Utah Pathology Services has 14 pathologists and serves three hospitals in the Central Urban Region of **Intermountain Healthcare**, the state's largest integrated delivery network. .

Utah Pathology Services will use its affiliation with PSA to beef up its sales and marketing. It is recognized nationally for its pathology expertise in the fields of urology, dermatology, gastroenterology, and gynecology. Its goal is to expand specimen referrals from office-based physicians. It will also utilized PSA services in billing and other management areas.

CHARLOTTE, NC BEGINS COMMUNITY BLOOD BANK TO SERVE 10 HOSPITALS

DISSATISFACTION WITH BLOOD BANKING services offered by the **American Red Cross** encouraged hospitals in Charlotte, North Carolina to partner in developing their own blood bank.

In recent months, the **Community Blood Center of the Carolinas** (CBCC) began full operations. It serves 11 North Carolina counties, three South Carolina counties and provides full blood banking services to ten hospitals representing more than 6,000 licensed beds.

Laboratory administrators and pathologists from **Carolinas HealthCare System**, **Gaston Memorial Hospital**, **NorthEast Medical Center**, **Piedmont Medical Center**, and **Presbyterian Healthcare** were involved in planning and implementing this project.

Organizational efforts turned serious in 2001. The following year, the **North Carolina Hospital Association** sponsored a state meeting. Representatives from 50 North Carolina hospitals met to explore alternatives for blood suppliers other than the American Red Cross.

One conclusion from this meeting was that a statewide effort would be an ambitious undertaking. The decision was made to first develop a regional blood supply resource. The partner hospitals of CBCC engaged the help of **Astraea, Inc.**, the parent company of **Virginia Blood Services** in Richmond, Virginia to do a feasibility study. CBCC opened using the Virginia Blood Center's FDA blood license.

CAROLINAS HEALTHCARE OPTS FOR TRIPATH'S LIQUID PREP & SCREENING

ALONG WITH A NEW COMMUNITY BLOOD BANK, there's another change under way in Charlotte, North Carolina. One of the nation's largest healthcare systems is converting its thin-layer Pap smear technology.

Carolinas HealthCare has completed its switchover to **TriPath Imaging, Inc.'s** automated liquid preparation and automated screening products for cervical cancer screening. Carolinas HealthCare is a health system with 15 hospitals and 4,410 licensed beds and operates a successful laboratory outreach testing program. TDR

Hospital Mergers Down For Fourth Straight Year

Merger and acquisition activity declines in response to a variety of market factors

CEO SUMMARY: Changes in hospital ownership often drive laboratory restructuring projects. But hospital merger and acquisition activity has declined for four consecutive years. Consequently, comprehensive laboratory restructuring efforts have declined in parallel. Hospital M&A numbers for 2003 are predicted to remain at a low level. Meanwhile, cross-system laboratory ventures seem to be also languishing.

FOR THE FOURTH CONSECUTIVE YEAR, the number of hospital mergers and acquisitions in the United States declined by a significant amount.

Hospital mergers and acquisitions often drive subsequent laboratory consolidation. The decline in such merger activity directly contributes to a decline in laboratory consolidation projects.

For 2002, only 163 hospitals were involved in mergers or acquisitions. This was a decline of 40% from 2001, when 267 hospitals found themselves in such deals. The number of transactions also fell by a similar amount, 37%. Only 60 transactions were closed in 2002, compared to 95 deals the previous year.

This data comes from *Modern Healthcare's* ninth annual survey of hospital consolidation activity. THE DARK REPORT tracks these numbers annually and was first to correlate the hospital merger boom of 1995 to 1998 with the tidal wave of hospital laboratory consolidation that occurred between 1997 and 1999.

Different trends in hospital merger and acquisition activity directly drive changes in the laboratories of the hospitals involved. For 2002, hospital merger activity shifted away from larger urban institutions. A larger share of such deals involved rural hospitals.

New Twists To Trend

That trend is predicted to continue through 2003, with some interesting twists. "Fewer organizations have jumped to acquire larger hospitals relative to three and four years ago," noted Bruce Gordon, Analyst at **Moody's Investors Service** in New York City. "Fewer are willing to take the risk."

According to Gordon, the operational integration of big hospital mergers has not yielded the benefits that owners expected. That should not surprise most laboratory directors and pathologists, who've seen these projects from the inside.

Instead of deals involving bigger urban hospitals, most merger activity in 2002 involved community hospitals

that wanted to acquire neighboring facilities. The two biggest deals for the year were **Ascension Health's** purchase of the eight-hospital **Carondelet Health System** in St. Louis, Missouri and **HCA's** acquisition of the 13-hospital **Health Midwest** system in Kansas City, Missouri.

Financial Pressure To Sell

Predictions are that most merger and acquisition activity during 2003 will focus on rural hospitals, particularly those with ailing finances. Likely buyers for these hospitals will be investor-owned private hospital companies because they have a stronger capital base and are actively seeking to acquire not-for-profit hospitals.

The slackening pace of hospital mergers and acquisitions since 1999 can be attributed to two different factors. First, by 1998, consumers were moving away from enrollment in closed-panel, gatekeeper model HMOs. As insurers reacted by offering out-of-plan options, hospitals felt less pressure to be part of a region-wide organization as a strategy to counter sole-source, capitated managed care contracts.

Second, by 1999 hospital administrators were dealing with the challenges and difficulties of integrating the multiple hospitals in their integrated delivery network. It was taking too much effort to generate even modest benefits from cross-facility integration.

These dynamics were reflected by developments in laboratory services. In 1999 and 2000, there were many examples of projects to link laboratories between two systems. The first, and largest, was the combination of laboratories in Milwaukee's 12-hospital **Aurora Health Systems** with Chicago's 8-hospital **Advocate Health Care**. *(See TDR, April 17, 2000.)*

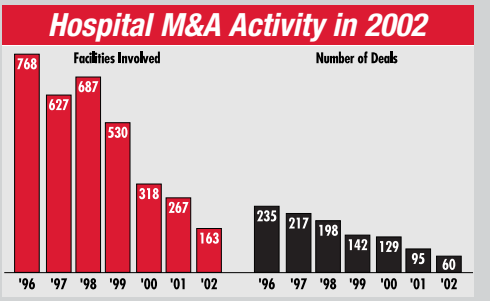
Stopped At Talking Stage

The Milwaukee-Chicago super-lab consolidation effort continues to operate. But other projects to consolidate and unify laboratory testing services across two or more health systems never got past the talking stage. Some have unraveled, like the marriage of the **UCSF and Stanford Health** systems in Northern California.

The linkage between changes in hospital ownership and laboratory restructuring is often overlooked when assessing lab industry trends. Based on current hospital merger data from the *Modern Healthcare* survey, it appears that 2003 will be a quiet year for hospital laboratory restructuring across the United States. TDR

Hospital Dealmaking Declines In 2002

This chart shows how the hospital merger & acquisition boom of 1996-1999 fueled hospital lab consolidation in those same years. But since 1999, the number of hospitals involved in M&A has fallen significantly. For 2002 and 2003, the majority of hospital deals involve institutions in suburban or rural areas.



Note: includes deals completed and pending in 2002. Includes mergers, acquisitions, joint ventures, long-term leases,and other partnerships.
Source: Modern Healthcare

Answering Our Mailbag–1

Liquid Prep Testing Market Causing Much Aggravation

SEVERAL RECENT ISSUES of THE DARK REPORT addressed issues that resonated with our clients and regular readers. The mailbag has been plenty full of late.

These responses are interesting in their own right. Among those with a point to make is **Laboratory Corporation of America Holdings**. It wanted to respond to a recent opinion and commentary column titled "Why There's 'Bad Blood' Against the National Labs." In that column, R. Lewis Dark, our Publisher Emeritus, tackled a touchy subject.

His topic was the collaboration between hospital labs and the national public laboratory companies—or the lack thereof. Within the laboratory marketplace, some hospital labs view the national public lab companies as a useful resource. However, there exists a sizeable number of hospital labs that have no interest in doing business, in any fashion, with public lab companies they view with "disdain," (Mr. Dark's characterization).

Frustrated Efforts At Amity

As an example of how such polarization occurs, he offered the story of a major tertiary center hospital laboratory in the South. This lab, which competes for physician office lab testing, has been frustrated in its attempts to establish an amicable working relationship with one of the two blood brothers. *(See TDR, January 20, 2003.)*

Essentially, the story is this. Hospital lab uses one brand of liquid prep Pap smears, national lab uses another brand. When a physician mistakenly misdirects a liquid prep specimen to the national lab that was intended for the hospital lab, the national lab refuses to cooperate in getting that specimen rerouted to the hospital laboratory. Instead, it returns the specimen directly to the referring physician with a note stating that "the wrong liquid prep specimen collection kit was used."

As most laboratorians know, long-standing professional practice in most communities is for lab competitors to cooperate in getting misdirected specimens to the correct laboratory. Not surprisingly, the hospital lab folks in this particular Southern town are disappointed that, at a minimum, this practice of their public lab competitors across town delays the misdirected specimen, which affects patient care by increasing turnaround time. Additionally, such extra handling increases the odds that specimen integrity could degrade, also a patient-unfriendly outcome. In his opinion and commentary, R. Lewis Dark did not identify the offending "blood brother."

Not long after publication of this story, THE DARK REPORT heard from LabCorp on this issue. They wanted to put their company's position into the public record.

"Since we are headquartered in the South, we were concerned that your readers might conclude that the incident you wrote about involved LabCorp," stated Bradford T. Smith, Executive Vice President at LabCorp. "It did not. First, we are proud of the

hundreds of mutually beneficial relationships we have with hospitals.

"Second, for years, LabCorp has offered both the Cytyc ThinPrep® and Tripath Imaging SurePath® brands of liquid preparations technologies for Pap smear screening," he continued. "Offering both of these technologies allows the physician to decide which method is best for his/her patients.

"Our policy for misdirected lab specimens works in in tandem with this support of physician choice. Whenever specimens and requisitions meant for another laboratory are received by us, LabCorp's corporate practice is to notify that lab and cooperate in efficiently getting those specimens to them," explained Smith.

"Our goal is to minimize the amount of disruption experienced by physicians and patients created by unexpected situations," he added. "Patient care should always be the guiding principle."

Voted With His Feet

Liquid preparation Pap smears were also the topic of another letter in our mailbag. However, this writer wanted to add his comments to observations about Cytyc Corporation that THE DARK REPORT recently published in its February 10, 2003 issue. This letter was written by William Pesci, Jr., Executive Director of the **Carolinas Lab Network** in Charlotte, North Carolina.

Dear DARK REPORT,

Again you are accurate in your evaluation of the lab marketplace. In the most recent issue, you stated that "one interesting development in the marketplace may also be a quiet revolt by Cytyc's laboratory customers against certain of its business practices" and that "some of Cytyc's customers may be voting with their feet when contracts [for liquid prep test kits] come up for renewal."

Count our laboratory as one of those who took a hike! We've completed our validations and are switching over from Cytyc's ThinPrep to TriPath Imaging's SurePath. The primary motivation for evaluating an alternative was Cytyc's basic business approach. On pricing, for example, despite increasing our annual volume of liquid prep tests, we were not offered lower pricing. That's probably not news to other labs using this test.

But what we've learned is that Cytyc itself is willing to compete against our laboratory in the markets we serve. Once Cytyc suspected a switchover was eminent, we understood that competing labs were approached and asked if they could handle additional Pap test volume from Charlotte. Cytyc representatives have historically marketed directly to our clients, sometimes creating confusion and problems for our lab. This has often left us on the hook to repair relationships with our clients. I'd like to know if any other laboratories are experiencing this same type of issue with Cytyc.

It is fortunate that we have competition in liquid prep Pap tests. It allowed us to vote with our feet and move our business to another vendor. Once again, THE DARK REPORT confirmed a marketplace trend that we are experiencing first-hand. Thanks for insightful reporting!

Editor's Response: Market share is won or lost by the sum total of individual customers like Carolinas Laboratory Network. THE DARK REPORT is interested to learn about other examples of questionable business behavior that might help lab administrators better understand unfolding trends. **TDR**

Contact Brad Smith at 336-584-5171 and William Pesci, Jr. at wpesci@carolinas.org.

Answering Our Mailbag–2

Lab Director Takes a Stand On Patented Genetic Testing

THIS LETTER APPEARED in the mailbag after our special intelligence briefing on how genetics will transform healthcare and before our look at how high-priced specialty esoteric testing is causing budget headaches for regional labs. *(See TDRs, December 30, 2002 and January 20, 2003, respectively.)*

Financial Pinch In Detroit

In Detroit, the 130 hospital laboratories participating in **Joint Venture Hospital Laboratories** (JVHL) already feel the financial pinch caused by high-priced specialty esoteric testing, regardless of whether the test incorporates genetic-based technology. JVHL Executive Director Jack Shaw had this to say about the growing problem:

Dear DARK REPORT,

While the future benefits of genetic testing for laboratory medicine are to be applauded, we, the local and regional hospital lab providers, are currently caught in a pronounced cost problem with respect to managed care and genetics testing.

A growing number of specialty testing companies charge outrageous (my term) rates for their patented genetics testing. Local laboratories find it nearly impossible to pass along the cost of much of this testing because of several factors. Included in any list of these types of specialty lab testing companies are ***Athena Diagnostics***, ***LipoScience***, ***Lipomed***, ***Myriad Genetics***, *and* ***Prometheus Laboratories,*** *among others.*

One major issue is billing. Managed care contracts with payers are written to cover CPT-4 ranges. These specialty genetics testing companies fit their "square peg" testing into "round hole" codes. CPT-4 fee schedules were not established to cover specialty tests with list prices of $1,500 or more.

The financial consequences are obvious. Under client bill scenarios, the hospital laboratory recovers only a very small percentage of the cost of such tests. If the hospital laboratory tells the specialty test company to directly bill the insurance plan, either of two unfavorable consequences results.

One, because the specialty test company refuses to par with health insurers, they balance-bill the patient for the amount unreimbursed by the health plan. Frequently, in this situation, some health plans pay charges to avoid a patient-pay situation and, if the lab contract has a risk-sharing provision, the hospital lab eats the cost for this test.

Alternatively, the insurance plan pays their normal fee schedule to the specialty test company. The patient then gets a bill from the specialty testing company for the balance. After hearing a complaint from the patient, the physician pressures the hospital laboratory to pay the difference because the laboratory sent out the test—albeit at the physician's direction.

Hospital laboratories do not always succumb to this pressure, but often they

concede because they don't want to risk losing their physician-client.

There is another competitive dynamic in dealing with these high-priced specialty tests. In the Detroit metropolitan area, our hospital laboratory network is unwilling to roll over and let a national laboratory, like ***Quest Diagnostics****, fill our market position just because Quest has deeper financial pockets to absorb per-test losses. It may even have an agreement to buy these tests at deep discounts or be involved in a joint venture with the genetic diagnostic companies that developed the patented lab tests.*

As THE DARK REPORT is well aware, hospital laboratories do not have capital to invest in these genetic testing companies or buy a joint venture position. In the near term, hospital laboratories can neither buy these tests at a reasonable wholesale price, nor can they duplicate these patented tests in their local market.

I see compelling evidence that the major imbalance between the cost of existing patented genetic tests and current payer reimbursement will widen. One reason is because these genetic test companies are bypassing our regional laboratories and are marketing their tests directly to physicians and consumers. The marketing model used by ***Cytyc Corporation*** *to introduce its patent-protected ThinPrep® Pap test is being copied by a growing number of specialty diagnostic companies.*

At least Cytyc spent time and money getting appropriate CPT-4 codes for their new lab test. This gave our hospital laboratories the opportunity to work with health insurers to develop a reasonable reimbursement model. I have yet to see any of the emerging specialty genetics testing companies copy this part of the Cytyc marketing model.

How are we coping with the high costs of patent-protected genetic tests at JVHL? Some of our hospital laboratories contact physicians who order these tests. Pathologists discuss with the ordering physician the cost of such tests and review the clinical benefit for the patient.

It is a time-consuming method to manage utilization. Further, it is not a good solution to challenge clients based on the cost of testing. But the options hospital laboratories have now are limited. This is one ugly side to genetic testing. It prevents laboratories from fully embracing the opportunities that some specialty genetic testing can bring to clinicians.

In closing, the special issue of THE DARK REPORT on how genetics will transform medicine was most thought-provoking. However, I want to directly challenge statements in that story that the full impact of genetic lab testing are still a few years away. R. Lewis Dark is incorrect if he thinks that laboratories will be relatively unaffected in the near term. Too late! The high cost of specialty genetic testing is one of the two top issues in Joint Venture Hospital Laboratory Network's managed care contract agendas for 2003!

Editor's Response: Jack Shaw describes a host of challenges and problems. Not the least is that the two blood brothers often have preferential pricing agreements with some of these specialty testing companies—financial terms not extended to hospital laboratories. THE DARK REPORT has invited Jack Shaw to moderate a discussion on this issue at the upcoming *Executive War College* in New Orleans on May 6-7, 2003. Lab directors interested in this topic are encouraged to attend and participate in this discussion. **TDR**

Contact Jack Shaw at jshaw@jvhl.org.

Dark Index

Quest Finally Owns Unilab, New Market Cycle To Begin

2003 opens with four national lab firms removed from the competitive marketplace

PERSISTENCE FINALLY PAID OFF for **Quest Diagnostics Incorporated**. On February 26, it took ownership of **Unilab Corporation**, capping almost 11 months of effort.

In completing this acquisition, Quest Diagnostics completes the two blood brothers' acquisition sweep of mid-sized public lab companies during 2002. The familiar names of **American Medical Laboratories**, **Dynacare**, **DIANON Systems**, and **Unilab** are headed for history's dustbin.

For the record, during the past 12 months, Quest Diagnostics and LabCorp spent $2.9 billion on their acquisitions. Since 1999, the two blood brothers spent $4.4 billion on lab acquisitions. These are sizeable investments, particularly within the relatively small segment of diagnostic services.

What Next For Lab Industry?

This raises an obvious question: what comes next in the lab industry? Never before in the American healthcare system has there been such a concentration of ownership and market share for diagnostic testing.

Certainly the new competitive landscape for physicians' office sendout testing is going to change. But accurate predictions about the nature of these changes are impossible to make.

California will be the first regional market to experience changes that directly result from lab consolidation. One easy prediction to make is that Quest Diagnostics will begin to raise prices and extend less liberal terms for managed care contracts.

As THE DARK REPORT has noted in past issues, Unilab consistently inked managed care contracts at aggressively low prices. It was willing to do full-risk, capitated contracts at a price that was generally half what lab competitors in California were willing to offer. Expect any Unilab cap rates that are less than $1.00 per member per month to disappear as Quest Diagnostics renegotiates contracts it considers money-losers.

Reductions In Lab Staff

Staff reductions should also be expected. Quest Diagnostics now has five significant laboratory operations in California, including **Quest Nichols Institute** in San Juan Capistrano. There are ample opportunities to eliminate redundant operations. Of course, there will not be announcements of large downsizing. Rather, staff reductions will be done quietly, phased in over time. Normal employee attrition will be used to full advantage in achieving lower staffing targets.

Quest Diagnostics is not wasting any time with its integration efforts. It reassigned two executives from the East Coast. Paul Rust and Douglas Boyle are becoming full-time California residents

and will lead the Unilab integration for Quest Diagnostics. As this news became known, at least one Unilab executive has already resigned. Jeff Lanzolatta, who was the Division President for Southern California, left the company last week, within days of the ownership change.

Antitrust Issues

One significant development in 2002's lab acquisition frenzy was the **Federal Trade Commission's** (FTC) heightened interest about the potential of the Quest/Unilab transaction to violate antitrust laws. At one point, the FTC was ready to oppose the deal. *(See TDR, October 7, 2002.)*

In fact, Quest Diagnostics divested certain assets in Northern California as a way to resolve antitrust concerns of the FTC. It sold a package of managed care contracts, rapid response labs, and patient service centers to **Laboratory Corporation of America**.

Entering this new market cycle, lab administrators and pathologists should watch two aspects. First, will antitrust regulators become more aggressive in blocking or reshaping future acquisitions by either of the national lab companies? Second, in California, will LabCorp successfully use these acquired assets to capture additional market share?

Establishing A Precedent

It is uncommon for one lab to sell managed care contracts and part of a regional service infrastructure to another laboratory. Observers wonder whether physician-clients served by Quest Diagnostics under these contracts will become loyal to LabCorp after the switch.

Mundane changes to test requisitions, a shift in couriers and pick-up times, introduction of new service procedures; all these tend to create disruption in physicians' offices. Frequently this disruption is enough to cause physicians to switch their business to a competing laboratory. LabCorp's success at retaining this customer base—and its ability to expand market share from this base—will make an interesting case study one year from now.

Moving from California to the national market scene, the disappearance of American Medical Labs, Dynacare, and DIANON Systems as independent competitors creates short-term opportunities for regional competitors. In many areas around the country, aggressive hospital lab outreach programs are recruiting some of the best management and sales talent from local business units of these acquired companies.

...what will be left for most laboratory customers is a default option: "the flavor is cola, you can select either Pepsi or Coca Cola."

More specific effects caused by the removal of these lab companies as independent competitors will take time to appear. For one thing, these companies did provide customers with choice. Each had its unique business strategies and operational strengths. As these companies are absorbed by their acquirer, what remains for laboratory customers in many cities is a default option: "the flavor is cola, you can select either Pepsi or Coca Cola."

Of course, both Quest Diagnostics and LabCorp will each argue that it has a unique business proposition that sets it apart from the competition. However, region by region, local hospital laboratory outreach programs would argue otherwise. They see the daily delivery of service by all competitors in their market. None yet report that any laboratory competitor has moved the service bar significantly above the norm. TDR

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Not too many issues ago, THE DARK REPORT was bemoaning the fact that the pathology profession has yet to replace those pathologist-entrepreneurs of the 1970s and 1980s who built some of the largest laboratory companies still operating today. But that overlooks recognition to pathologist Tom Grogan, M.D., who is a founding partner of **Ventana Medical Systems**, based in Tucson, Arizona. Grogan is the sole finalist among 30 nominees for **Ernst & Young's** *Entreprenuer of the Year* award in Arizona. This makes Grogan automatically eligible for possible selection as the national *Entrepreneur of the Year*.

ProxyMed Inc., based in Fort Lauderdale, Florida, is a firm worth watching. It recently bought **MedUnite**, the healthcare dot.com electronic clearing house founded by several of the nation's largest health insurers. It is working diligently to create capabilities to link physicians' offices with other providers, including clinical laboratories.

WHY ER'S DON'T ORDER ALCOHOL AND DRUG TESTS

Here's evidence that lawsuits, lawyers, and insurance company activities do affect how some physicians order and use laboratory tests. On February 26, 2003, *The Wall Street Journal* reported that "most of the nation's emergency rooms and trauma centers don't routinely run blood alcohol tests or 'tox screens' on patients thought to be intoxicated." This situation is a result of decades-old laws in 38 states and the District of Columbia that "give insurers the option to deny medical reimbursements to patients under the influence of alcohol or narcotics." ER doctors know that insurance companies can deny claims if the lab test results appear on patient records. The WSJ quoted Larry Gentilello, M.D., Chief of Trauma and Surgical and Critical Care at **Beth Israel Deaconess Hospital** in Boston. "Doctors don't test because they are afraid they won't get paid," he said.

ADD TO: ER Testing

Alcohol and drug-related injuries are believed to play a role in as many as half of all emergency room visits annually. Because of this fact, billions of healthcare dollars are affected by state laws that allow insurers to deny coverage. Dr. Gentilello and others have launched a campaign to reform or repeal these laws.

P.S. to ER Testing:

In a related item, lawmakers continue to struggle with drugs-of-abuse issues. The Arkansas State Legislature recently passed a law making it "illegal to sell or use 'clean urine' for the purpose of passing a drug or alcohol test."

More intelligence is leaking out of **IMPATH, Inc.** about the abrupt departure of its long-time Chairman and CEO Anu D. Saad, Ph.D. in an expense account scandal. As reported last issue, Saad resigned following an accounting review of expenses from the past three years that revealed a "lapse of corporate integrity." Saad will repay $250,000. Since that disclosure, several sources have confirmed that the amount of questionable expenses was significantly higher. One source claimed the number was actually as high as $2.5 million. IMPATH has not provided additional details about this matter.

That's all the insider intelligence for this report. Look for the next briefing on Monday, March 24, 2003

PREVIEW #3

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