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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

Commentary & Opinion by...

R. Lewis Dark

Founder & Publisher

Doctors, Hospitals & HMOs Take Their Turn

IT MAY BE PREMATURE OF OUR EDITOR TO PREDICT that increasing numbers of HMOs will choose to withdraw from state Medicaid programs during the next 24 months. *(See pages 4-6.)* But I do think he is on target with his observations that hospitals, physicians, and insurance companies will not let government healthcare regulators push them around.

A careful study of how HCFA and other government healthcare regulators dealt with the clinical laboratory industry reveals a pattern. On the reimbursement side, clinical laboratories have endured ten years of consistent cutbacks to laboratory reimbursement. This was accomplished in a variety of ways, but the end result was always the same: laboratories got less money.

On the regulatory side, laboratories saw compliance guidelines and coding/reimbursement requirements become increasingly complicated and burdensome. The net effect of this has been to constrain utilization, inhibit how laboratories market tests to clinicians, and complicate their relations with physicians over the issue of providing diagnosis codes.

For ten years, government healthcare regulators have attacked the clinical laboratory industry, both directly and indirectly. Government healthcare regulators got away with it because the industry failed to speak with a united voice in the earliest phases. Even today, laboratory ownership is too fragmented to develop an effective lobbying force.

That will not be true of doctors, hospitals, and insurance companies. Billions of dollars are at stake, and all three groups are well-organized. They can meet with legislators and influence healthcare-related bills. Using advertisements and commercials, they can present their message directly to the public.

Having HMOs decide to abandon their state Medicaid programs is a new phenomenon. The more I learn about the reasons why this is happening, the more I believe that government healthcare bureaucrats will want to make them the whipping boy. I will predict that, sometime in the next two years, we will see a media blitz that talks about how heartless HMOs are denying Medicaid beneficiaries from the quality healthcare to which they are entitled.

Of course, the press will not broadcast the fact that government reimbursement for these Medicaid services is continually reduced, without reducing certain benefits as appropriate. Just as the clinical laboratory industry had their day in the target sights of healthcare bureaucrats and prosecutors, soon it will be the turn of doctors, hospitals, and insurance plans. But the outcome may be very different than that experienced by clinical laboratories. **TDR**

Bio-Reference Labs Buys New York-Based Medilabs

Acquisition activity by this publicly traded laboratory helps sustain multi-year growth

CEO SUMMARY: Here is an independent commercial laboratory that shows sustained growth while it maintains profitable operations. One key strategy is the selective acquisition of laboratory business in small, profitable chunks. The sales price paid for Medilabs demonstrates how much decline has occurred to the value of clinical laboratories.

DESPITE THE PROFIT SQUEEZE on commercial laboratories, a limited number of acquisitions continue to occur. However, most of these deals involve special circumstances and do not represent large transactions.

Bio-Reference Laboratories, Inc. (BRLI) of Elmwood, New Jersey announced last Thursday that it would acquire **Medilabs**, a small regional laboratory in Valley Cottage, New York.

Bio-Reference Laboratories will pay not more than $7 million to buy Medilabs. Medilabs is a division of **Long Term Care, Inc.**, also based in New York. Medilabs' net revenues during fiscal 1997 were approximately $14.7 million.

Bio-Reference Laboratories serves New York City and the tri-state area of New York, New Jersey and Pennsylvania. Medilabs is based on the west bank of the Hudson River, just above the Tappan Zee Bridge, so its service area is complementary with that of Bio-Reference Laboratories.

"Because the activities of Bio-Reference and Medilabs overlap in many markets, there will be an opportunity to promote efficiencies by combining the two operations," stated Marc Grodman, M.D., President and CEO of BRLI. "Further, senior management of Medilabs has agreed to remain with the combined entity."

For Bio-Reference, this is the latest in a regular pattern of trading for chunks of laboratory business. During the past three years, Bio-Reference made several purchases. It even bought the dialysis testing business of **SmithKline Beecham Clinical Laboratories** at the end of 1996.

As a result of this careful acquisition strategy, Dr. Grodman has quietly

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built the laboratory's net revenue from $22.9 million in fiscal 1994 to $38.7 million in fiscal 1997. With the addition of Medilabs' $14.7 million in revenue, Bio-Reference will have doubled in size during the last five years.

Operating Profits

The challenge for Bio-Reference, as with its commercial laboratory competitors, is to maintain and increase operating profits and net earnings. For the most recent quarter ending January 31, 1998, Bio-Reference's net income was a paltry $37,993 on quarterly revenue of $8.9 million. This demonstrates the razor-thin profit margins common to commercial laboratories operating in aggressive managed care markets.

The stock price of Bio-Reference Laboratories reflects the challenges for improving net income and earnings per share. Recent stock prices were $1.74 per share. The stock has fluctuated between a low of $0.71 and a high of $2.18 during the last 12 months.

Laboratory Valuation

Another market trend which is validated by the Medilabs acquisition is current valuation levels for commercial laboratories. Bio-Reference is paying a price which is less than 0.5 times Medilabs' annual revenue. This price is in line with other recent laboratory acquisitions. It certainly demonstrates the decline in market value for commercial laboratories since the glory days of 1993-94. At that time clinical laboratories could get a purchase price that was equal to 1.0 to 1.25 times annual net revenues.

Bio-Reference Laboratories makes a good bellweather for market conditions on the east coast. The healthcare markets in New York state are undergoing wrenching change as traditional reimbursement arrangements for financing hospitals in that state are revamped.

Managed care companies in New York and New Jersey are struggling to maintain financial solvency. Several HMOs are pulling out of state Medicaid programs. Commercial laboratories are affected by the market turmoil. Bio-Reference and its laboratory competitors must provide testing services into this relatively hostile healthcare environment.

Despite the financial pressure from declining reimbursement, Bio-Reference seems to have a viable strategy for achieving economies of scale within its regional market area. Growth by acquisition means that BRLI can maintain a sizeable market presence. Such a strategy may permit Bio-Reference Laboratories to survive while its regional competitors fall by the wayside. TDR

(For further information, contact Marc Grodman, M.D., at 201-791-2600.)

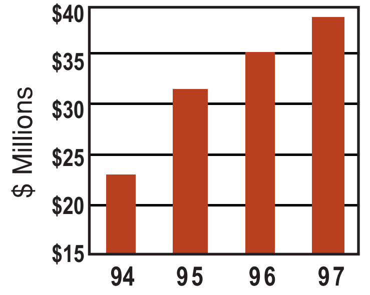
Bio-Reference Labs Shows Steady Growth

Over the most recent four years, Bio-Reference Laboratories has demonstrated strong growth in net revenues.

FISCAL YEAR	NET REVENUE	NET INCOME
1994	$22.9	$1.1
1995	$31.5	$1.4
1996	$35.1	$0.6
1997	$38.7	$3.2 *
1998	Est. $53.4	

**Reflects one-time sale of certain assets*
a. Chart is in millions.
b. Fiscal year ends October 31.

Four Year Revenues



Industry Analysis

HMOs Abandon Medicaid In Several Eastern States

HMOs plead "poverty," government cries "foul;" truth about Medicaid problems lies in-between

By Robert Michel

CEO SUMMARY: In a number of states, certain HMOs have ceased servicing Medicaid patients. This trend will grow. It is the spearpoint for a coming battle between government healthcare programs and private healthcare providers: what level of reimbursement is adequate to provide appropriate care? Who gets to set the reimbursement levels?

LABORATORIANS SHOULD PAY CLOSE attention to a trend now surfacing in eastern states. A number of HMOs, claiming high costs, are withdrawing their services from Medicaid patients.

Aetna/U.S. Healthcare recently terminated coverage for Medicare beneficiaries in Connecticut and New York. It claimed high cost was the reason. **Oxford Health Plans** is pulling out of New Jersey and Connecticut. **United Healthcare** left the Ohio Medicaid program last year, as well as a Medicaid program in Missouri. THE DARK REPORT predicts that more HMOs will follow the example of these large insurance companies.

On the surface, the issue revolves around "high costs." But the more fundamental conflict will be attempts by the government to arbitrarily force reimbursement levels lower, while compelling HMOs and healthcare providers to continue providing services.

This should sound familar to most clinical laboratory executives. For more than ten years, the laboratory industry has labored under arbitrary and capricous dictates from healthcare bureaucrats. On one hand, it suffered through year-to-year reductions in reimbursement levels. On the other hand, it was given increasingly onerous and convoluted guidelines for submitting reimbursement claims.

But the more fundamental conflict will be attempts by the government to arbitrarily force reimbursement levels lower, while compelling HMOs and healthcare providers to continue providing services.

Because the laboratory industry represents only 4% to 5% of total healthcare expenditures, it has been a relatively impotent lobbying force when compared to physicians, hospitals and insurers. That impotence is why the laboratory industry has endured counterproductive government policies applied years ago. Similar types of enforcement and reimbursement policies are increasingly being applied to other segments of healthcare.

But this time the government will run up against tougher opponents than the clinical laboratory industry. Physicians, hospitals, and insurance companies have substantially more clout with both legislators and the public. Unlike laboratories, these healthcare groups will make their complaints heard by all segments of society.

Opening Moves

An analysis of the issues causing HMOs to terminate their Medicaid programs reveals the opening moves in a battle between private providers and the government. For the most part, as HMOs cease Medicaid participation, they state that costs were higher than expected.

Government officials who administer Medicaid have a different perspective: the problem is not cost management, it is simply that HMOs don't do a good job anticipating costs. Bruce Bullen, Medicare Director for Massachusetts and Chairman of the **National Association of State Medicaid Directors**, states, "HMOs got into the business, but didn't understand the Medicare line of business."

According to Bullen, those HMOs are leaving because they don't have the stomach to deal with the complex problems of caring for the poor. Bullen's rhetoric is right from the pages of history's class warfare warriors. A closer look at the facts tells a different story.

Severe Cuts

State after state has imposed severe cuts to Medicaid reimbursement. New York's experience is representative. First, its Medicaid program provides an ample benefits package which exceeds some private plans. It offers over-the-counter drugs like aspirin and transportation to and from a physician's office.

Despite this generous benefits package, New York State slashed reimbursement to HMOs from $171.22 PMPM in 1994 to $129.92 PMPM in 1997. This is a 29% reduction in reimbursement! Ohio dropped its Medicaid rates by 19% from 1994 to 1997. Indiana announced a 19% reduction last fall, from $112 PMPM to $91 PMPM. The resulting outcry was loud enough that the state only cut reimbursement by 8%, to $103 PMPM.

Laboratory executives should be sympathetic to the plight of HMOs on this count: it is tough to create effective operating budgets when the government arbitrarily lowers reimbursement without an off-setting reduction in the Medicaid benefits package.

In reality, these reimbursement cutbacks are attempts by the goverment to control costs by fiat. Healthcare executives make exactly that charge. Referring to New York, not-for-profit **Bronx Health Plan's** CEO, Maura Bluestone says the state "talks about its health-care goals, but it really has approached this whole program as [a source of] budget savings for itself."

Lack of Foresight

A respected financial analyst discusses the real problem–the lack of intelligent foresight and planning by government officials. "States have been so concerned about saving money in the short-term," stated Kenneth Abramowitz of **Sanford C. Bernstein & Co.**, "that they undermined their long term chances of cost containment. It's government stupidity at its highest level."

THE DARK REPORT predicted earlier that a major battle is forming between patient choice and government direction of healthcare. The fact that HMOs are beginning to refuse participation in state Medicaid programs means that the battle lines are forming. Clinical laboratories will find themselves in the midst of this conflict, but with little power to affect the outcome.

Just last Thursday, the Justice Department announced that it would take a less agressive approach in pursuing allegations of Medicare fraud by hospitals. (Notice that the announcement did not include any mention that physicians, clinical laboratories, home healthcare agencies, and long term care facilities would get similar relief.)

This public statement is a direct result of lobbying by hospitals. Such lobbying resulted in the submission of a bill by Representative Bill McCollum of Florida. McCollum's bill would weaken the government's ability to use the False Claims Act against hospitals. The bill already has 70 co-sponsors in the House of Representatives.

Healthcare Financing Crisis

THE DARK REPORT predicts the rising cost of healthcare, combined with increased utilization by a growing number of senior citizens, will intensify the healthcare financing crisis. Government's response will be to use the power of laws to arbitrarily reduce reimbursement to all classes of healthcare providers. Simultaneously, there will be laws requiring providers to offer services, or face criminal prosecution.

Obviously, at some future point, rigorous laws in these areas would put private healthcare providers in a squeeze: one set of laws reimburses their services at below cost. Another set of laws makes it illegal to refuse treatment.

THE DARK REPORT believes that such a scenario will not come to pass. The withdrawal of HMOs from Medicaid programs, should it become widespread, would precipitate a public debate before the problem became intractable.

Laboratorians should watch how this HMO/Medicaid battle unfolds. Implicit in the government's position is the power to force healthcare providers, including laboratories, to provide services regardless of whether reimbursement is adequate or not.

As this coming battle develops, clinical laboratory executives should understand the underlying issue: will the American healthcare system be based on patient choice and free market principles, or will it be controlled and directed by the government? TDR

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

Private HMOS Decide To Exit Medicaid

Here is a summary of private HMOs which decided to withdraw from participation in the Medicaid program in these states. Expect to see similar withdrawals by other private HMOs during the next 24 months.

Company	*Members Affected*
Aetna/US Healthcare	26,000 in NY 6,000 in CT
Oxford Health Plans*	45,000 in NJ 33,000 in CT
United Healthcare	40,000 in OH 17,000 in MO
Pacificare Health Systems	60,000 in CA
Conventry Health Care	22,000 in FL

*NJ effective 7/1/98

Sources: Healthcare Financing Administration, company and state reports

American Path Resources Bought By Pathology PPM

Pathology Consultants of America doubles in size with purchase of Nashville-based APR

CEO SUMMARY: Here is first confirmation that Pathology Consultants of America has indeed purchased American Pathology Resources. The combination of the two pathology-based physician practice management companies demonstrates that the pathology industry is on the verge of rapid transformation.

PATHOLOGISTS SHOULD EXPECT 1998 and 1999 to be years of fast-paced, even radical change. Traditional business models of pathology are about to undergo rapid transformation.

The catalyst for this change is the nascent trend involving pathology-based physician practice management (PPM) companies. Evidence to confirm the reality of this impending transformation comes from the announcement by **Pathology Consultants of America** (PCA) that they signed a definitive agreement to acquire **American Pathology Resources** (APR). Both companies are headquartered in Nashville.

Definitive Agreement

"Discussions were launched between our two companies in late December," stated Brian Carr, President of PCA. "The definitive agreement to purchase was signed last Thursday. We expect the sale to close by April 30."

Terms of the deal were not revealed. It was a stock for asset purchase and involved no cash. It was known that APR was struggling from the debt burden and financial terms relating to its buy-out in 1994 from former owners, **Laboratory Corporation of America.** Prior to the buy-out, APR was known as **Reference Pathology Laboratories.**

Strategic Business Plan

"Our strategic business plan gets a big lift from this acquisition," noted Carr. "In particular, APR's two anchor practices in St. Louis and Nashville are perfectly matched to our market model. Both practices are respected regional providers with strong market presence. In fact, APR brings us seven pathology practices and 41 pathologists. This brings to 71 the number of pathologists managed by PCA."

From THE DARK REPORT'S perspective, the more interesting aspect to this transaction is the fact that PCA will retain certain members of APR's executive team, for very good reasons. PCA's interest in APR's executives reveals much about the management directions PCA intends to pursue.

"We got a very competent management team that did some remarkable things at APR during the last 18 months," noted Carr. "Lawrence Kloess III was APR's Chief Operating Officer. For us he will become Vice President of Operations. David Bourgeois was Senior Vice President, Acquisitions. At PCA he will become our Vice President of Development and Strategic Planning. Rick Ferguson, APR's Vice President of West Coast Operations will join us as Vice President of Operations."

Execute Strategies

"What we do is sell our ability to execute strategies in a local market as a partner with the pathologist," explained Carr. "We do it with a parallel financial incentive model. So what we sell is only as good as the management people on our team. That is why we appreciate what the executives at APR accomplished during the last year."

According to Carr, American Pathology Resources originally started out as an employee model PPM. "Back in 1995, APR went to market with this employee model PPM," observed Carr. "For a lot of reasons, it was not successful. Late in 1996, APR reinvented itself.

"APR restructured itself into an equity model pathology PPM. In late 1996, it became an equity partner with an eight-pathologist practice in St. Louis," he continued. "During the past year APR built an off-site histology laboratory. During the same year, this practice expanded. It now numbers 20 pathologists and enjoys a diversified and growing revenue stream.

Different Business Plan

"From our perspective," said Carr, "it was no small accomplishment for the management team at APR to successfully reposition the company from an employee model PPM to an equity model PPM. Its successes, like the St. Louis project, demonstrates the capabilities it adds to PCA.

"At PCA we are building for the future," he explained. "We believe that it is the quality of the people on our management team which creates success. Our philosophy is built upon creating value for our practice partners.

"For example, we told our Denver practice that it was impossible for us to build value for them from Nashville," Carr continued. "The way we would build value for them is with an on-site practice administrator in Denver. This is the person who is local and who will execute the day-to-day strategy. This individual will manage the sales force. He will negotiate managed care contracts. He will be out in the community to build the pathology practice's presence in the market.

> ***"PCA will always have significant pathologist ownership and direction. It is a company that was created by pathologists for pathologists. That makes it unique among pathology PPMs operating today."***
>
> **Brian Carr**
> *President, PCA*

"That is how you build value. Our job at headquarters in Nashville is to give that practice administrator the tools, the support and the leadership to make things happen in Denver, where it counts. We understand that it is good management execution at the local level which makes the difference. It is the ability to block and tackle better than the competition which insures financial success and a growing market share for our pathology practices in each community."

PCA's acquisition of APR serves notice that this new pathology PPM intends to become an aggressive, profitable competitor in the marketplace. Expect to see Pathology Consultants of America move swiftly to carve out its place in the pathology marketplace. TDR

(For further information, contact Brian Carr at 615-665-4608.)

Second In A Special Series

Selling A Pathology Practice: Do's, Don'ts & Pitfalls To Avoid

CEO SUMMARY: Physician practice management (PPM) companies represent a powerful new economic trend. Greater numbers of pathologists will soon confront a career-changing decision: should we sell our pathology practice to a PPM? Regardless of how pathologists answer that question, their business will not stay the same. This second installment of our special series addresses the "do's and don'ts" of selling a pathology practice. Here is practical wisdom and insight into the sales process. It is a messy process, because it involves money, emotions, and radical disruption to the status quo.

ECONOMIC FORCES ARE TRANSFORMING the profession of pathology. During 1998 and 1999, the most obvious catalyst for change will be pathology-based physician practice management (PPM) companies.

These pathology PPMs must buy pathology practices to create the revenue base necessary to support their business plan. It is known that at least seven or eight pathology PPMs are organizing to compete against **AmeriPath, Inc.,** the first publicly traded pathology PPM.

There may be as many as nine or ten pathology PPMs in the market by year's end. Each PPM will canvas the country and attempt to convince pathologists that they should sell their practice. This unrestrained acquisition activity will blow through the pathology profession like a free-wheeling hurricane.

Unfortunately, many pathologists are unprepared for the acquisition hurricane soon to hit their community. The purpose of this article is to alert and equip pathologists for the coming storm. Armed with better knowledge about the sales process, pathologists can negotiate more effectively with financially sophisticated buyers.

"The hurricane is a good metaphor," stated Christopher Jahnle, Managing Director of **Haverford Healthcare Advisors,** a financial services firm based in Paoli, Pennsylvania. "The odds of riding out a hurricane with minor damage are excellent when someone has advance warning and time to get ready. But when they don't prepare for the hurricane, the worst can happen and often does.

"That is why pathologists are well-advised to gain basic knowledge about the sales and acquisition process before they enter into negotiations to sell their practice," recommended Jahnle. "Most pathologists probably remember a few years back when physician colleagues rushed to sell their practices to hospitals. Once the consequences of having a hospital administrator run his practice became obvious, many a physician came to regret the speedy decision to sell his practice to the hospital.

"This same dynamic is one that pathologists would do well to avoid," Jahnle noted. "Since it is difficult to unwind these deals once they are consummated, it is better for pathologists to do their homework in advance of launching negotiations to sell their practice."

Jahnle is intimately familiar with such situations. Haverford Healthcare Advisors has probably valued and packaged more pathology practices for potential PPM sales than any single entity. As an advisor to these pathology practices, Jahnle had a birds-eye view of the internal wrangling which accompanied the prospect of selling the pathology practice.

"My list of essential do's and don'ts when selling a pathology practice come directly from watching pathologist partners wrestle with the financial and emotional issues triggered by sale negotiations," observed Jahnle. "No one should discount the emotional intensity of the partners when changes to income, control and lifestyle must be discussed."

Common Alignment

"My number one thing to do is to have common alignment of motivations and objectives among the practice partners," he said. "Why do you want to sell? What kind of price is agreeable to the partners? How will the practice operate after the sale?

"Answers to these questions are not simple," he added. "Each pathologist in a practice is affected differently by a sale. Expect to find intense emotions attached to specific issues. That is why it is essential that the partners establish a common framework for why they would consider a sale and what they want the sale to accomplish.

"My second essential thing to do relates to making decisions," said Jahnle. "Before commencing negotiations, develop a mechanism for your group to expeditiously evaluate complex issues and make decisions. You want your group to speak with a unified voice, representing the variety of inter-

Jahnle's 5 "Do's"

1. ***Do align motives and objectives of all pathologist partners before commencing sales negotiations.***
2. ***Do develop a mechanism for evaluating complex issues & making expeditious decisions.***
3. ***Do have realistic expectations about the purchase prices before launching sales negotiations.***
4. ***Do retain outside expertise in valuation, legal, and management to guide the sales transaction.***
5. ***Do be persistent and patient. It generally takes six to eight months to consummate a sales transaction.***

ests which exist within any pathology practice around the country."

Jahnle had an interesting example of how the absence of a pre-agreed process for making decisions can cripple discussions within the pathology practice. "In one instance, we represented a practice of 18 pathologists. Their partnership agreement required a unanimous vote to sell the practice or affiliate with a PPM. The original goal of the partnership agreement was to provide the partners with an equal voice.

Potential Buyer

"In negotiations with a potential buyer, the offer involved a huge amount of money," he explained. "As it turned out, 17 pathologists voted to sell. One younger pathologist couldn't make up his mind. He voted against it."

"You can imagine the tension within the practice triggered by that one negative vote. Today they are still independent. But that process of having 18 partners meet twice a week for four to six weeks to evaluate the sales offer caused them to revamp their governance process.

"They modified their partnership agreement, which in itself was a painful process," said Jahnle. "Now there is a governance structure which is built around a management committee of the business manager and three pathologist partners. Today that pathology practice has the organizational structure to expedite making decisions while including input from the pathologist partners."

Price Expectations

The third item on Jahnle's list of things to do involves purchase price expectations. "It is crucial that the partners have realistic expectations about the market value of their pathology practice," he explained. "It is similar to when a seller lists his residence for sale. If the owner lists the price too high and brings the house to market, the most interested buyers will tour the house and refuse to make an offer because of the unreasonably high price.

"To avoid losing your most qualified buyers, it is essential to understand how the marketplace values your pathology practice," he continued. "Having the practice appraised and valued before putting it up for sale is frequently done. Not only do the partners learn the value range for their practice, but they can identify management projects which would legitimately increase the price prospective buyers would be willing to pay. The valuation has an added benefit. It often helps the partners develop a consensus before the sales process begins."

Number four on Jahnle's "to do" list involves outside expertise. "Most pathologists will sell a practice once in their lifetime," he pointed out. "Legal, valuation, tax, and operational considerations make the sales process complicated and fraught with potential exposure in subsequent years.

"For that reason, it is recommended that they engage specialists with extensive experience," advised Jahnle. "Pathologists have one opportunity to do it right. Outside expertise can maximize success."

Complex Legal Issues

"For example, legal issues are extraordinarily complex. State prohibitions against the corporate practice of medicine and regulations affecting fee-splitting require sophisticated legal expertise to keep the pathologists compliant and on the right side of the law.

"Add to that the complications of the purchase agreement, the management service agreement, non-compete covenants and similar issues," said Jahnle. "It is easy to see why the lawyer who prepared your will or gives you tax advice is quickly outgunned on these matters. It reinforces the importance of having top-flight legal counsel represent your interests during the sales transaction."

Last of the "to do" items for Jahnle is persistence and patience. "Pathologists must keep in mind that it takes from six to eight months to negotiate and resolve all the issues involved in the sales transaction. Because of the multitude of details, it can be wearing to continually negotiate without a definite closing date."

Remain Patient

"That is why it is essential for pathologists to remain patient and persistent. Their goal of a consummated sale is attainable. Patience is particularly important, because pathologists tend to be very analytical. They can study a deal to death without making a decision. That is another reason why patience, combined with good outside expertise, is the combination which makes for a win-win sales transaction between buyer and seller."

Jahnle also has a list of five essential "don'ts." "Number one on this list is don't limit negotiations to just one prospective buyer or PPM. That should be a prime directive.

"I have seen occasions where a pathologist falls in love with the first buyer that comes a-courting," recalled Jahnle, "Worse yet, if it's a bad deal, things can drag out for months, causing the pathologist to miss the market window of opportunity.

"Another important dynamic works in the pathologists' favor when negotiating with multiple buyers," added Jahnle. "Discussions move faster. There's competitive pressure on the buyers to offer reasonable terms and conclude the sale. With just one buyer, the deal can string out.

"There is another positive benefit to meeting with several pathology PPMs," he said. "After hearing the presentations and meeting with the executives from these companies, pathologists who might be skeptical of PPMs and cynical about their perceived 'get rich quick' schemes gain a better understanding of how these companies actually work. It

Jahnle's 5 "Don'ts"

1. ***Don't fall in love with the first buyer. Play the field to get the best offer.***
2. ***Don't sell your practice without meeting all the management team and visiting pathology practices already in the PPM.***
3. ***Don't sell on price alone. Sell on the best combination of price and terms.***
4. ***Don't be embarrassed about receiving a large amount of money from the sale. The market sets value for the practice.***
5. ***Don't wait for the window of opportunity to close. Move deliberately when the seller's market is most favorable.***

also permits the selling pathologists to evaluate and compare both the business plans and the management teams of each PPM."

The second "don't" on Jahnle's list relates to due diligence. "Don't sell your practice without doing two things beforehand. First, meet all the key executives and managers at the PPM who will be working with your particular practice. Evaluate their competence and develop personal chemistry. After all, these are the people who are going to be working to make your pathology practice successful."

Visit Pathology Practices

"Second, take the time to visit pathology practices which are already part of the PPM," he continued. "The best way to learn if the PPM can deliver what it promises is to spend a day or two at one of its pathology practices. By investing time getting to know your future PPM partner, you will better understand the advantages and disadvantages of your future relationship."

Jahnle's third "don't" on the list involves purchase price. "Don't concentrate on the offer with the highest purchase price. More often than not, the offer with the highest purchase price is not the one selected by the sellers. There are dozens of transaction parameters which much be negotiated.

"These transaction parameters have great influence on working conditions, future profit distributions and opportunities to expand the practice's revenue base," stated Jahnle. "I can identify maybe 50 deal parameters that could be compelling enough to make someone choose to accept a lower purchase price.

"Number four on my list is interesting," he continued. "Don't be embarrassed by the fact that selling the practice may cause a pathologist to realize substantial wealth. In some cases, there is guilt that they might receive a large sum of money for their practice. There could be feelings that patient care will suffer, or their sale makes it more difficult for younger pathologists to succeed.

"It is important for pathologists to realize that these acquisitions are driven by established market pricing mechanisms," noted Jahnle. "Payment multiples of five to seven times earnings are supported by the financial markets.

"Further, the marketplace is transforming healthcare and pathology," he explained. "Acquisition of pathology practices by PPMs will occur. During the next five years, both young pathologists and older pathologists who chose to continue practicing medicine will be required to adapt to these new business models. That is why pathologists should not

Jahnle Describes One Big Pitfall To Avoid

"Confidentiality is important to the process," noted Jahnle. "Before starting discussions, get a signed confidentiality agreement from each prospective PPM partner.

"It is also important to keep the entire matter confidential from employees and non-essential people until the day of the closing," he added. "That is the proper time to make an announcement, and communicate effectively with clients and employees alike."

Who generally spills the secret? "It is not the PPM," notes Jahnle. "Almost invariably it is a pathologist who tells someone at golf or lunch. There is a high probability of a good deal going sour when word gets out. That is why it is best to maintain absolute confidentiality until the day the deal closes."

Pathology's Generation Gap Affects Decision To Sell

What impact does the sale of a pathology practice have upon younger pathologists? This is an unsettling issue when the senior generation has the opportunity to "cash-in" on a lifetime of work.

"A substantial number of older pathologists feel like their retirement needs are satisfied," stated Christopher Jahnle, Managing Director of Haverford Healthcare Advisors. "They are interested in providing their younger colleagues with an independent place to work. During PPM negotiations, these pathologists consider the career interests of their younger partners as terms are negotiated."

For younger pathologists, the healthcare world looks very different than it did when the senior generation graduated from medical school. With managed care reshaping and integrating healthcare, the future will contain fewer independent private practice opportunities. Instead, because of the growth of specialty AP firms and PPMs, there will be a greater number of salaried positions.

This trend can be seen at companies which provide national pathology services. ***DIANON Systems, Inc.*** *and* ***UroCor, Inc.*** *offer salaried posi-tions. As their anatomic pathology specimen volumes grow, both companies are adding*

feel guilty about selling their practice for a large sum of money."

Timing Affects Sales Price

"Number five on this list involves timing," said Jahnle. "Don't wait too long to investigate an affiliation with a PPM. Timing has a great deal to do with prices. Let me explain.

"Remember that, as recently as 1994, a clinical laboratory could be sold for 1.0 to 1.25 times annual net revenue. Today, most clinical laboratories would be offered a purchase price closer to 0.5 to 0.7 times annual net revenue. That is a significant reduction in price in a four-year period.

"I expect to see a similar change in pricing for pathology practices," noted Jahnle. "During 1998 and 1999, the newly-emerging pathology PPMs will need to acquire pathology practices to build their revenue base. They will bid against each other to acquire the best pathology practices.

"But at some period, the marketplace will change. Acquisitions are expensive. Pathology PPMs will begin to emphasize management and marketing as the preferred methods for improving earnings. At that point, multiples paid for pathology practices will inevitably decline.

"That is why I believe we have an 18 to 24-month window where pathologists have the best opportunity to sell their practice for the highest price and best terms," predicted Jahnle. "At some future point, market forces will naturally shrink the prices paid for pathology practices."

When pathologists consider whether or not to sell their pathology practices, Christopher Jahnle's list of do's, don'ts and pitfalls to avoid becomes a valuable road map. It can guide pathologists away from the potholes and toward a successful sales transaction. **TDR**

(For further information, contact Christopher Jahnle at 610-407-4024.)

Pathology PPM Appears Ready To Hit Marketplace

Physician Solutions brings aboard new CEO, finalizes $20 million venture fund commitment

CEO SUMMARY: After several months of delays, Physician Solutions recruited a new CEO and completed arrangements to receive $20 million in venture capital funding. These two milestones mean that the pathology-based physician practice management company will soon be ready to launch formal business operations.

EVENTS ARE UNFOLDING RAPIDLY at **Physician Solutions**. During the month of March, the company recruited a seasoned healthcare veteran to be the new CEO, closed a transaction for $20 million from venture capitalists, and announced plans to relocate from Nashville to Dallas.

Physician Solutions becomes the second pathology-based physician practice management (PPM) company to obtain major funding from venture capitalists. **AmeriPath, Inc.** was initially funded by venture capitalists in 1994-95 and successfully went public last October.

In contrast to AmeriPath, however, Physician Solutions intends to pursue a different plan for acquiring and operating pathology practices. It will utilize the equity model as opposed to AmeriPath's use of the employment model.

The new Chairman and CEO at Physician Solutions is Richard D'Antoni. He was formerly Chief Operating Officer (COO) of **ProMedco**, a public PPM. "Richard D'Antoni brings considerable expertise to us," stated Harold Roe, President of Physician Solutions. "At the time he joined ProMedco, it was a private company with $30 million in annual revenues. Last year ProMedco reached a $225 million run rate and successfully closed an initial public offering which raised $33.5 million.

> **"Now that we have closed the commitment for $20 million in venture capital funding, we are ready to enter the marketplace and tell our story to pathologists."**
> **Harold Roe**
> *President, Physician Solutions*

D'Antoni assumed responsibilities at Physician Solutions on March 10, 1998. Within a few weeks of D'Antoni's arrival, the company finalized details and closed the commitment for $20 million in venture capital funding.

The $20 million funding commitment was larger than the $18 originally reported *(see TDR, December 8, 1997)*. "Given the input from D' Antonio and revisions to our projections, the venture capital companies decided that $20 million was an appropriate amount," explained Roe. "Also, we added an additional venture capital firm. **The Sprout Group** and **21st Century Health**

Ventures remain as participants. The new venture capital company is **Salix Ventures** of Nashville, Tennessee.

"Salix Ventures was formed by two executives with a long history of healthcare and PPM management," he noted. "Chris Grant was an executive with **MediVision** back in the early 1980s. It was one of the first PPM-model companies at a time before the term PPM was used to describe physician practice management firms. His partner is David Ward, a former executive with **MedCath**, the big cardiology PPM."

Capital Brings Credibility

The funding of $20 million from venture capital companies is important credibility for Physician Solutions. But pathologists will find two other facts equally credible.

First is the source of the venture capital. The Sprout Group is an affiliate of **Donaldson, Lufkin & Jenrette** (DLJ), the Wall Street brokerage firm. DLJ acted as the lead underwriter for AmeriPath's initial public offering. Apparently DLJ likes the prospects for pathology-based PPMs.

21st Century Health Ventures is an affiliate of **HEALTHSOUTH**. Coincidentally, HEALTHSOUTH owns the largest number of surgicenters in the United States. Since HEALTHSOUTH's surgicenters generate a steady volume of anatomic pathology (AP) specimens, it can be assumed that a close relationship with a possible provider of AP services was of interest to 21st Century's parent company.

Second is the involvement of experienced executives familiar with the PPM industry. The background of Richard D'Antoni is directly relevant to the business needs of Physician Solutions. Grant and Ward, partners in the third venture capital firm funding Physician Solutions, have a similar knowledge about the PPM industry. The fact that such individuals are willing to invest time and money into Physicians Solutions indicates their confidence in the company's potential for success.

Different Business Plan

Pathologists will find that Physician Solutions has a different business plan than AmeriPath. "Our strategy is to emphasize the local nature of pathology," said Roe. "We want to find pathology practices with good growth potential and a solid reputation, located in metropolitan areas where pathology consolidation has yet to occur.

"This strategy calls for us identify a promising area and plant a flag there by partnering with a likely pathology practice," he continued. "We would then go north, south, east, and west to build a regionalized pathology service organization within that metro area. For our pathologist partners, we would help them diversify their revenue."

"Many pathology practices have most of their revenue tied up around a single hospital or healthcare system," he added. "In many cases, the pathologists' revenue is under the control of a single hospital administrator. One aspect of our game plan is to market pathology services and expand client accounts within that region. The increased volume of AP specimens brings higher income and creates a diversified stream of revenue."

Roe uses the term partnering deliberately. He wants to distinguish his pathology PPM model from that of AmeriPath. AmeriPath has been using the employment model PPM. AmeriPath buys the assets of the pathology practice and puts those pathologists on an employment contract.

In contrast, Physician Solutions uses the equity model. The company will buy an ownership interest in the pathology practice. It will take a portion of practice profits in exchange for a variety of services such as administration, billing, sales and marketing. A profit-sharing formula allows both the pathologists and Physician Solutions to benefit from increased profits which result from the combined efforts of both parties.

Diversify Revenue

Pathologists should recognize that Physician Solutions' impending arrival into the marketplace speeds up the pace of change to a sleepy profession. It joins AmeriPath as a well-funded company intent on building a significant business from anatomic pathology.

Also entering the pathology marketplace is **Pathology Consultants of America** (PCA). News of their recent acquisition of **American Pathology Resources** *(see pages 7-8)* makes PCA the third company now building anatomic pathology revenues through selective acquisition. Several other pathology-based PPMs are known to be organizing and lining up venture capital.

These pathology PPMs will compete against each other in two ways. First, they will seek to buy or partner with a particular type of pathology practice. Since there a limited number of such practices, bidding wars may fuel a seller's market for those pathologists lucky enough to be in such a high-profile practice.

Second, as these pathology PPMs acquire a presence in various cities, they will launch aggressive, persistent sales programs to capture market share. THE DARK REPORT sees evidence of this already starting to occur in Florida. *(See in-depth coverage on this topic, TDR, March 2, 1998.)*

Thus, pathologists should carefully watch the business progress of Physician Solutions and similar pathology PPMs. They represent the force of change to the quiet backwater once known as the profession of pathology. **TDR**

(For further information, contact Harold Roe at 615-370-5370.)

Government Must Pay Whistleblowers $42.3 Million From SBCL's "Labscam" Case

Last Wednesday a federal judge in Philadelphia ruled against the Justice Department and ordered the government to pay three whistleblowers $42.3 million.

After **SmithKline Beecham PLC** settled a $325 million allegation of Medicare fraud, the Justice Department agreed to pay a minimum of $9.7 million to the Robert J. Morena, Charles W. Robinson, Jr. and Glenn Grossenbacher. But the payment offer was good only if the three whistleblowers agreed to drop their claims for the additional $42.7 million.

In hearing the case, U.S. District Judge Donald VanArtsdalen ruled that the three men made a major contribution to the government's case and helped bring in nearly all of the settlement. "I am left with the impression that the attorneys in charge of the Labscam investigation... seek to take far more credit for the overall success of the proceedings than is rightly due," wrote Judge VanArtsdalen.

Judge VanArtsdalen ruled that the three individuals were responsible for all but $15 million of the amount recovered from SmithKline. He awarded the whistleblowers about 17% of the $325 million settlement. This ruling strengthens the rights of whistleblowers and will encourage further whistleblower suits.

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Last Thursday was the 20th Annual Conference of the **Biomedical Marketing Association** (BMA). Held in Baltimore, it brought together the marketing and sales executives from diagnostics companies all over the United States. The program focused on changes to how hospitals and laboratories purchase diagnostic equipment and supplies.

MORE ON:...BMA

Consolidation within the diagnostics industry is influencing how diagnostics instruments are marketed. Executives from both **Novation** (**VHA**) and **Premiere** made presentations. Each of their purchasing organizations is creating a new emphasis on contracting for laboratory services and equipment. Contract compliance remains an issue for both organizations.

ADD TO:...BMA

Since many of the executives in attendance at the BMA are involved in both total laboratory automation (TLA) and modular automation, it was a good opportunity for THE DARK REPORT to take an informal poll about TLA. Without question, individuals with hands-on experience on TLA projects expressed frustration. Most felt that there were no short term prospects for TLA products. Modular automation, on the other hand, seems to be growing and shows good investment returns.

Apparently the financial performance of clinical laboratories continues to be dismal. When **WDI Capital Market**s released their quarterly listing of healthcare company earnings, the category for clinical laboratories was missing. Leading the pack, however, was the biotechnology segment. For fourth quarter 1997, their collective earnings were up 184%. Second on the list was home healthcare, with an increase of 125%. At the bottom? Practice Management companies were down -74%. Diagnostics was the next poorest category, at -69.7%.

MINNESOTA HMOS POST LOSSES IN 1997

Minnesota HMOs are struggling financially, just like the national HMOs. **Medica Health Plans**, part of **Allina Health Systems**, lost money on a premium base of $1.7 billion for 1997. Across town, **HealthPartners** posted a loss of $9.9 million against premium revenues of $1.3 billion. **Blue Cross/Blue Shield of Minnesota** also posted a net loss from operations. This is more evidence of the general erosion of finances among the HMO industry.

That's all the insider intelligence for this report. Look for the next briefing on Monday, May 4, 1998

THE DARK REPORT

UPCOMING...

- *Managed Healthcare In Minneapolis: Surprising Evolution Of Healthcare Impacts Clinical Laboratories.*
- *First Quarter Earning Releases By Public Laboratories Reveal Impact Of Changed Pricing For Laboratory Tests.*
- *Innovative Hospital Laboratory Grabs Huge Outreach Volumes With Small Investment In Capital.*
- *Regionalization Of Pathology Services Makes Small Pathology Practices Vulnerable.*