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From the Desk of R. Lewis Dark...

THE DARK REPORT

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

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R. Lewis Dark

Founder & Publisher

Making $1 Billion Disappear

MOST PEOPLE WOULD AGREE WITH ME THAT $1 BILLION IS A HUGE AMOUNT of money. It generally takes the federal government to squander amounts that big. The **Internal Revenue Service's** $2 billion computer boondoggle is the latest example of government incompetence with taxpayers' money.

So I feel I will be in good company when I express my surprise and disappointment upon learning that the three national laboratories, plus two public labs in California, are in the process of writing down an incredible sum of money from their balance sheets. The story on page 10 discusses how **Quest Diagnostics**, **Unilab** and **Physicians Clinical Laboratories** have already written down more than $550 million of intangible assets from their balance sheets in the last fiscal year. Apparently, neither **Laboratory Corporation of America** nor **SmithKline Beecham Clinical Laboratories** has yet declared how they will handle this issue. Should they also write down similar percentages of their intangible assets, the laboratory industry total will most likely exceed $1 billion!

This is really a black eye for management of the laboratory industry. It directly reflects on their poor stewardship over the last five years. I say that because these write-downs come on top of two other significant financial events for the same companies. First, the publicly traded laboratories have paid the federal government almost $1 billion to settle allegations of Medicare billing fraud. Second, during the last two years, several (but not all) of the public laboratories have taken special charges as a result of internal problems. I'll bet if somebody totaled up those special charges since 1994, the number would exceed $500 million dollars.

At my age, I have earned the right to be opinionated, and my opinion is that this group of three national laboratories, including their acquired predecessors, along with their two California-based brethren, should not be proud of how they dissipated as much as $2.5 billion of their company's money and assets during the last five years. Why do I hold this opinion? Because I see many independent regional laboratories still operating comfortably in the black throughout the United States. They had the management acumen and discipline to run their business profitably. They succeeded in the same declining clinical laboratory marketplace served by the public laboratories.That being the case, maybe the public laboratories should borrow a page from the independent regional laboratories' book. After all, nothing succeeds like success, and the regional independents have proved that they know how to provide good service and still make money!

AmeriPath Stock Offering Pulled By Underwriters

Efforts to become first publicly traded pathology management firm stymied by market conditions

CEO SUMMARY: Ameripath planned to go public in March. However, the stock market's significant decline and further evaluation of the company's business plan caused Wall Street underwriters to defer issuing the stock. Pathologists are curious as to whether AmeriPath's "employee" business model influenced decisions about the public stock offering.

UNDERWRITERS on Wall Street decided to delay **AmeriPath's** Initial Public Offering (IPO). Their action represents a significant setback for AmeriPath.

AmeriPath hoped to raise $71.7 million selling 36% of the company's shares to the public. If successful, AmeriPath would have become the first publicly traded physician practice management company exclusively devoted to pathology.

For that reason, pathologists throughout the United States watch AmeriPath with keen interest. Professionally, pathologists are challenged by declining income and the pressure to consolidate pathology practices. Any business model which can solve either or both of these problems will be rapidly copied.

"For AmeriPath, the decision to delay or cancel the stock offering must be a tremendous blow," stated one pathologist who closely tracks the company. "From the beginning, AmeriPath's driving goal was to go public. Without a public market for their stock, it becomes a very different business vehicle for the pathologists who sold their practices to AmeriPath."

As of December 31, 1996, AmeriPath had acquired 12 pathology practices in five states. At that time, 81 pathologists were employed by the company. Consolidated revenues are $82 million per year. During the "quiet period" since the company's S-1 filing with the **Securities and Exchange Commission**, no additional pathology practices were acquired.

Company officials still decline to speak publicly about their situation,

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

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so specific reasons why the IPO was delayed or cancelled remain unknown.

When THE DARK REPORT detailed AmeriPath's plans and the business strategy of the company earlier this year *(See TDR, January 27, 1997)*, AmeriPath was preparing to offer their stock by March 31, 1997.

Several events may have changed that timetable, particularly as the stock market declined significantly over the last four weeks. AmeriPath was looking to offer 6.2 million shares at $14.00. Such an offering would generate net proceeds of $71.7 million.

Underwriters apparently believed that the market would not take AmeriPath's stock at that price. THE DARK REPORT learned that underwriters were only willing to offer 4 million shares at $10. This changed the economics of the stock offering for AmeriPath and its venture capital investor, **Summit Partners** of Boston. Instead of raising over $70 million, the revised offering would only provide $40 million, most of which was earmarked to pay existing bank debt. The decision was made to pull the IPO.

Another consideration which may have played a part in the underwriters' decision is AmeriPath's business structure. Unlike the majority of physician practice management companies, which use a "service fee" arrangement for sharing profits, AmeriPath's pathologists are employees and compensated by salary.

There is speculation that the underwriting syndicate questioned the productivity of pathologists who are to be paid salaries at a level below their previous earnings as part-

AmeriPath, Inc. Time Line

1994: Pathologists Evangelos Poulos, M.D.: Michael Demaray, M.D.; A.P. Kowalzyk, M.D.; and **Summit Partners** develop concept of pathology-based physicians practice management company. Company is based in Florida.

January 1996: James New is retained as AmeriPath's president.

February 1996: AmeriPath incorporated as the holding company for **American Laboratory Associates**, the precursor company. Two pathology practices are part of AmeriPath at this time.

June-November 1996: AmeriPath acquires ten additional pathology practices, bringing the total number to twelve pathology practices and 81 pathologists.

December 1996: AmeriPath files S-1 registration for an Initial Public Stock Offering with the Securities and Exchange Commission.

April 1997: Officials at underwriting syndicate and AmeriPath decide to delay or cancel AmeriPath's IPO.

*Coverage of AmeriPath in **THE DARK REPORT**: November 4, 1996; January 27, 1997* ners in the practices acquired by AmeriPath.

AmeriPath's potential to shed light on the employee/partner productivity debate comes from a remarkable fact. AmeriPath's consolidated financials for 1996 show revenue of $82 million. Thus, the company's 81 pathologists generate an average of $1 million per pathologist per year in revenue. This flies in the face of industry experience.

"Typically, hospital-based pathologists generate $400,000 to $600,000 per year in revenue," stated a pathology business consultant. "That is well below AmeriPath's average of $1 million per pathologist. Either they have a management productivity secret we need to learn, or those numbers will not be sustained in coming years by AmeriPath's pathologists."

Strategic Plans

Although AmeriPath's initial public offering will not take place at this time, company officials intend to press forward with AmeriPath's strategic plan.

During the last six months, company executives continued discussions and presentations with a number of pathology practices around the United States. THE DARK REPORT believes that AmeriPath will attempt to do two things during the next year.

First, AmeriPath will continue to acquire pathology practices. Funds for this effort will come from venture capital sources and credit lines from banks or similar lenders. Summit Partners will play a key role in helping AmeriPath access capital through these sources.

Second, look for AmeriPath to arrange a second attempt at an IPO. This will probably not take place until last quarter of 1997 or first quarter of 1998.

Now that AmeriPath's IPO has been scratched, the company must demonstrate healthy earnings to convince Wall Street that a second attempt at an IPO is valid. Acquiring additional practices will help increase Ameripath's 1997 earnings over the same time periods of 1996.

Also, look for AmeriPath to concentrate on acquiring dermatopathology practices. This is a high-yield segment of the pathology marketplace and makes it easier for AmeriPath to show the earnings necessary to meet Wall Street's expectations.

AmeriPath Moved Ahead

During 1996, AmeriPath moved far ahead of any competing pathology rollup company. It now has an $82 million revenue base, ample support from a credible venture capital company, and assumably a checkbook that is open and ready to purchase more pathology practices.

Notwithstanding arguments concerning the merits of the employee versus equity business model, AmeriPath now possesses the resources to demonstrate whether their model of pathology consolidation can be successful.

Marketplace Challenges

AmeriPath must deal with the same marketplace challenges as all pathology practices: hospitals seeking to lower pathology costs, reductions to Medicare and Medicaid pathology reimbursement, and managed care plans offering less reimbursement.

Like all pathology practices, AmeriPath must deal with a financially stressful healthcare environment. Because they now have economies of scale unmatched by any other pathology company, the financial performance of AmeriPath will provide many valuable management lessons to the entire pathology industry. TDR

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

Great Debate...

Equity Model Versus Employment Model

THIS QUESTION of employee model versus equity model is a key distinction between the three pathology practice roll-up companies currently purchasing pathology practices.

Within the healthcare industry, there is still no consensus about what business models successfully encourage physician productivity and maintain the quality of healthcare services provided by those same physicians.

For example, just 18 months ago **Moody's Investors Services** warned hospital bondholders that those hospitals with large physician practice acquisitions were losing significant money on those practices. *(See TDR, December 18, 1995.)* At that time, Moody's Senior Analyst Lisa Martin told THE DARK REPORT that "We see a lot of cases where the physician practice component is losing money. There are instances where the losses equal, and even exceed, any income the hospital itself earns."

Because most hospital-owned physician practices work on an employee model, Moody's assessment provides evidence that the employee model may not be an effective business structure for physician roll-up companies.

The employee/equity model controversy is relevant to pathologists for an important reason. The price paid for a pathology practice by an employee model company such as AmeriPath can be significantly higher than what is paid by an equity model company.

"It is important to remember that a physician roll-up company which pays the pathologist a salary after acquiring the practice gains a greater portion of the cash flow," observed one financial analyst. "The pathologist agrees to a 3-5 year employment contract and probably gets some type of stock kicker as an incentive. For this reason, physician management companies using the employment model can outbid equity model companies when doing acquisitions.

"However, few of the publicly traded physician practice companies use the employee model," he continued, "so there is still a question about whether physicians and pathologists will maintain high levels of productivity and quality during the three-year to five-year term of their employment agreement.

"After all," he concluded, "they have gone from status as an equity partner to one of employee, at a much reduced rate of earnings. Human nature predicts that they would begin to ease off the pace under those circumstances.

"Many pathologists looking at AmeriPath's business plan have a question that can only be answered by actual demonstration," he continued. "What happens to pathology revenues when pathologists are employees, not partners?

"The key feature that distinguished AmeriPath from other pathology practice models is the fact that their pathologists are employees and paid on salary. Is the productivity of salaried pathologists equal to that of pathologists who are partners? Is that productivity difference great enough to give AmeriPath a competitive advantage when bidding against traditional pathology practices?

"The employment model is viewed as a threat by many pathologists," he explained. "That is why AmeriPath generates so much interest among the profession. That is also why every quarterly financial statement AmeriPath releases will be scrutinized by pathologists. AmeriPath provides the first opportunity to evaluate the impact of employment status on pathologist productivity and the profitability of pathology practices."

Success Seems Elusive To Pathology Innovators

AmeriPath's difficulties demonstrate challenges of introducing change to the pathology world

CEO SUMMARY: Attempts to organize pathology practice management companies encounter resistance and market impediments. Success requires an astute business plan and a sophisticated management team to convince pathologists to abandon proven practice models and affiliate with regional or national pathology companies.

PATHOLOGISTS ARE NOTORIOUS for their skepticism and resistance to change. However, during the last three years those qualities may have served them well.

Prior to **AmeriPath, Inc.**, no pathology "super practice" business model ever got off the ground. Thus, the innate business conservatism of pathologists prevented them from joining a concept that may have been ill-designed, poorly executed or simply ahead of its time.

AmeriPath is not the only "new" business model to hit the pathology marketplace. Others were tried. Even today several companies are recruiting pathology practices to sign up for their vision of pathology's future.

Astute pathologists can learn a great deal from the experience of these entrepreneurs. It is inevitable that forces now transforming healthcare will require pathologists to change the way pathology services are organized and delivered.

Probably the most visible national recruiter of pathology practices in recent years was **PATHCOR Inc.**, based in Oklahoma City. PATHCOR sprang from a concept developed by the owners of **Medical Arts Laboratories** in Oklahoma City during 1994. Throughout 1995 and early 1996, PATHCOR executives approached pathologists and held national meetings to drum up interest in their concept.

> ***AmeriPath is not the only "new" business model to hit the pathology marketplace. Others were tried.***

PATHCOR's business plan was to create a national pathology service organization centered around regional hubs. As the parent, PATHCOR would provide group purchasing, group billing and other administrative services. Using a management service agreement, non-pathologist related expenses would be deducted and the remainder of the revenue would flow back to the regional hubs and their participating pathology practices.

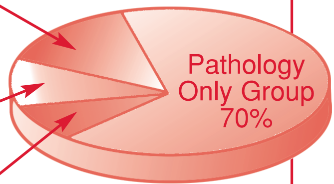
The concept was the brainchild of PATHCOR's President, Perry A. Lambird, M.D., M.B.A. Lambird, a

Pathology Is Ready For Consolidation

Because managed care contracts usually involve exclusive provider status for a large number of patients, managed care plans increasingly want to negotiate with pathology organizations capable of covering extensive geography.

As the neighboring tables demonstrate, pathology remains a highly fragmented profession. Almost 60% of the practices in the United States have five or fewer pathologists

Estimates are that 11,400 pathologists generate about $3.2 billion in net revenues annually. The highly fragmented nature of pathology means that the consolidation process will affect virtually all pathologists during the next five years.



Pathology Practices By Market Type

Pathology Practices By Revenue

Revenue ($000s)	# Practices	% Total Practices	% Total Revenues
<$300	1,835	55.6%	15.7%
$300-1,000	1,023	31.0%	26.2%
$1,001-2,000	221	6.7%	14.9%
$2,001-$7,000	197	6.0%	30.5%
>$7,000	24	0.07%	12.7%

Number of Pathologists In Practices

# Pathologists in Group	% of Pathologists	# Practices
Solo	9%	1,024
2-3	26%	1,183
4-5	23%	581
6-10	24%	341
>11	18%	171

Sources: College of American Pathology
Haverford Healthcare Advisors

pathologist himself, believed the time was ripe for a pathologist management company with national reach.

For a number of reasons, the PATHCOR concept never caught on with those pathology practices which studied the concept. Outside observers believe two factors contributed to the failure of PATHCOR to attract pathologist interest. First, PATHCOR never established a prototype regional hub system. Thus, it had no actual operating experience to demonstrate that service levels and economics were valid for their model.

Second, the business development team delegated to sell the concept was not effective. Industry observers give PATHCOR's Chief Operating Officer, Robert Savasten, high marks for both his business acumen and his efforts. But PATHCOR's use of Aaron Korngold, a healthcare consultant based on the east coast, always puzzled pathologists who looked at the PATHCOR model.

PATHCOR suffered a quiet death in the spring of 1996. The corporation could no longer maintain the overhead of an executive team which included at least eight individuals. Estimates are that PATHCOR's annual payroll exceeded seven figures.

Contemporary with PATHCOR's 1995-96 recruiting efforts were those of Nashville-based **American Pathology Resources** (APR). APR was formerly affiliated with **Allied Clinical Laboratory** and known as **Reference Pathology Laboratories**. After Allied was acquired by **National Health Laboratories** in 1994, pathologists and venture capitalists purchased the pathology operation, then revamped it and gave it a new name.

Throughout 1995, it was PATHCOR, American Pathology Resources and Ameripath which actively solicited pathologists...

During the first half of 1995, American Pathology Resources sent a mailing to pathology practices throughout the United States. The purpose of the mailing was to interest pathologists in APR's proposed pathology management model.

Response from the mailing must have been significant. During 1995, pathologists throughout the United States told THE DARK REPORT that, after receiving the mailing, they sent in a reply card indicating interest in learning more, but never heard back from APR. APR must have been inundated with responses.

During this time, American Pathology Resources based their pathology practice model on their regional success with a "circuit riding" approach they used in Tennessee. Rural hospitals were served by pathologists who visited each location on a predetermined schedule. Anatomic pathology specimens were processed at regional centers.

It was surprising that one major pathology practice which found APR's concept appealing was the group at **Scripps Clinic** in La Jolla, California. La Jolla is a heavily urban marketplace, so the regional concept that was effective in Tennessee apparently did not succeed in California. When the two-year agreement expired between APR and Scripps, the California pathologists decided not to renew it.

Practical Experience

During 1995 and 1996, American Pathology Resources gained practical experience and market feedback from their efforts to acquire and integrate pathology practices. APR then refocused its strategic business plan. It now structures its business organization around the equity model. It is still actively recruiting pathology practices to join their business. Recently a hospital-based pathology group serving a Southern California hospital signed with APR.

Throughout 1995, it was PATHCOR, American Pathology Resources and AmeriPath which actively solicited pathologists to join their business model of a national pathology company.

During 1996, two other organizations surfaced with regional or national pathology business models. **Pathology Service Associates** (PSA) of Florence, South Carolina became the first pathology network to actually deliver statewide pathology services. Unlike the other models, PSA is organized as a healthcare network. It provides network services to pathology practices which remain independently owned and operated.

After recruiting 14 pathology practices in South Carolina, PSA began servicing its first managed care contract in October of 1996. *(See TDR, September 3,* *1996.)* During the course of the year, PSA exhibited at pathology trade shows and conferences throughout the country.

PSA's Chairman is Louis Wright, Jr., M.D. According to Dr. Wright, the credibility of PSA and the fact that PSA is designed to support pathology locally at the point of care caught the attention of pathologists in several states.

Besides efforts to form an interstate pathology network linking PSA's participating pathologists in South Carolina with pathology practices in neighboring Florida, Georgia and North Carolina, the PSA concept is being exported to states as far away as Utah and California.

One reason why PSA enjoyed rapid success in attracting pathology practices outside the state of South Carolina is the fact that they waited until the business model was established and the network had signed managed care contracts to provide anatomic pathology services. PSA did not recruit pathology practices outside the state until these things occurred. Thus, PSA had a track record and real experience to share with prospective pathologist practices.

During 1996, another pathology practice management business model appeared in the marketplace. The firm is **Physician Solutions, Inc.**, based in Nashville, Tennessee.

Over the last 12 months, Physician Solutions has quietly approached a number of pathology practices. The company is organized to provide two services.

First, they offer basic pathology practice business management support. This is the traditional menu of strategic and practical business support for pathology practices.

Second, they offer a national pathology company model which is organized around an equity-sharing arrangement. The goal of this business model is to provide pathology practices with a consolidation vehicle that offers pathologists income driven by equity sharing.

Both American Pathology Resources and Physician Solutions use the equity model for compensating pathologists who sell their practices to the companies. In this respect, both companies are different from AmeriPath, which is using the employment model.

1997 Will Be Significant

THE DARK REPORT predicts that 1997 will be a watershed year for pathology practice consolidation. Pathology Service Associates, AmeriPath, Physician Solutions and American Pathology Resources will continue to market themselves aggressively to pathologists.

Their aggressive marketing coincides with the increasing presence of managed care in regional markets throughout the United States. The combination of the two forces will entice a number of pathologists to sell their practices.

Because each one of these four pathology consolidators is pioneering a business concept, THE DARK REPORT further predicts that there will be more financial disappointments than successes during the early years of this trend.

The reason is simple. Management, marketing and economics will play an increasingly greater role in the financial stability of pathology practices. These are skills that most pathologists never acquired as a complement to their highly developed clinical skills.

Yet precisely these talents will separate pathology winners from pathology losers during healthcare's transition to managed care. Already the earliest attempts to consolidate pathology have demonstrated several approaches which won't work. With time some of the current pioneers will find an effective business formula. TDR

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

Where's The Write-down? LabCorp Faces Key Decision

LabCorp still has not followed the example of competing labs in writing down goodwill

CEO SUMMARY: Commercial laboratories are recognizing declines in the market value of their assets. LabCorp has yet to do the same. Taken cumulatively, these write-downs demonstrate the sizable revenue erosion that large commercial laboratories experienced during the past three years. Soon it will be LabCorp's turn to address this issue.

MORE THAN $550 MILLION of clinical laboratory net worth disappeared from the balance sheets of public laboratories during the last twelve months.

This is a direct consequence of changes to the clinical laboratory marketplace during the previous three years. Further, this $550 million shrinkage of clinical laboratory net worth is directly linked to the reduced competitive ability of these laboratories to dominate the markets they serve.

Quest Diagnostics Incorporated (formerly **Corning/MetPath**), **Physicians Clinical Laboratories** (PCL) and **Unilab** already took major write-downs of intangible assets.

Laboratory Corporation of America has yet to formally address the issue of goodwill and intangible assets. If LabCorp were to take the same action as its competitors, it could decide to write-down intangible assets by as much as $355 million. *(See table on Page 12.)*

If that happened, it would represent a recognized loss of laboratory asset value approaching $1 billion in less than two years. The story behind this loss of shareholder value in commercial laboratories reflects several dynamics.

"Goodwill and intangibles are used to value those revenue streams of a laboratory which represent the service component," said Richard Michealson, Chief Financial Officer at Unilab. "This distinguishes goodwill and intangibles from property, plant and equipment. These are physical assets subject to depreciation."

If that happened, it would represent a recognized loss of laboratory asset value approaching $1 billion in less than two years.

"Laboratories are service companies," he continued, "so traditionally they have a higher proportion of intangible assets as compared to a manufacturing company. Under current accounting rules, companies are required to revalue intangible assets and goodwill whenever there are significant changes to the market value of those assets."

This is precisely the accounting requirement which caused Quest, Unilab and PCL to write down a substantial portion of their intangible assets during the last year. Three laboratory marketplace dynamics eroded these intangible assets.

The first dynamic involves goodwill. Whenever an acquiring laboratory paid too much to purchase a laboratory, it created an inflated value for goodwill. If the laboratory overpaid for the business it purchased, then excess goodwill needs to be adjusted downward at a future date.

Fundamental Changes

The second dynamic involves fundamental changes to the business itself. This reduces the value of intangible assets. For the laboratory industry, declining test utilization, reduced Medicare/Medicaid fee schedules and unprofitable managed care capitation rates dramatically cut the amount of revenue collected for medical tests. This directly reduced laboratory profits from the existing volume of tests.

The third dynamic can be categorized as mismanagement. Did the acquiring laboratory manage the newly purchased laboratories wisely? Were lost client revenues excessive during and after the transition to new owners? The negative revenue impact of mismanagement would require the value of intangible assets to be adjusted downward.

For LabCorp executives and its public auditors, the decision about when to properly write down goodwill and intangible assets, and by how much, represents an important decision for the future of the company. The potential size of the write-down in this area could approach $355 million. If so, then LabCorp would end up with a negative net worth.

It should be noted that such write-downs do not affect cash flow. But they do affect how the company's business is valued. A lower valuation can reduce the amount of credit extended and increase the interest rate of that credit.

It can be speculated that both LabCorp executives and their audit firm understand the dilemma which faces them. Were they to now revalue intangibles downward, they could affect the success of the impending $500 million stock offering. Were they to wait, they could subject themselves to investor lawsuits for withholding material facts.

How could the laboratory industry bleed between $500 million and $1 billion of net worth in just a few years? The **National Health Laboratories** purchase of **Eastside Medical Laboratories** in Seattle, Washington in early 1994 provides a revealing example. National Health paid approximately $22 million for Eastside. Eastside had about $20 million in annual revenues, with physical and financial assets of, say, $10 million. For accounting purposes, the difference between the purchase price and physical assets would be $12 million.

National Health, now part of LabCorp, would categorize that $12 million on its balance sheet as "intangibles." It would normally write down a small percentage of intangibles each year, similar to a depreciation account.

Disappearing Revenues

But what happens when revenues from the acquired laboratory shrink or disappear? In the case of Eastside, within 18 months of closing Eastside's lab and consolidating testing at LabCorp's Seattle division, it was reported that the facility was accessioning fewer specimens per day than before the Eastside acquisition.

If this is true, then it means that LabCorp paid $22 million for Eastside's $20 million revenue stream, but less than two years later those revenues had disappeared. So what happens to the "intangible" value on LabCorp's balance sheet?

As a public company, they should disclose the diminished asset value and write down an appropriate amount to

Balance Sheet Changes To Public Labs

(In $000s)	Intangibles Before	Write-Down Amount	Write-Down Date	Write-Down Per Cent
Quest Diagnostics	**$1,030.0**	**$445.0**	**12/31/96**	**43.2%**
Unilab, Inc.	**$196.1**	**$70.2**	**12/31/96**	**35.6%**
Physicians Clinical Labs	**$88.6**	**$36.3**	**2/29/97**	**41.0%**
Estimated write-down if LabCorp were to follow industry precedents:				
Laboratory Corp. of America	**$891.1**	**$355.**	**???**	**40.0%**

reflect current market value. Competing laboratories have already done this.

In 1996, auditors for Physicians Clinical Laboratories (PCL) revalued its corporate assets at current market value. PCL wrote down $36.3 million. A significant part of this involves the difference between the $55 million paid in 1994 for **Damon's** California laboratories and what those Damon revenues were worth to PCL in 1996.

When **Corning Clinical Laboratories** spun off from **Corning Incorporated** on January 1, 1997, Quest Diagnostics took a $445 million charge to bring corporate assets in line with current market value.

Industry observers agree that the company overpaid for **Damon Clinical Laboratories** and **Nichols Institute**, resulting in a large amount of overstated goodwill. Corning also did a poor job of integrating both companies into their laboratory system. Tens of millions of dollars of acquired revenue disappeared. The largest revenue losses probably came from Texas operations and Nichols labs in Kansas City and Sioux Falls.

Acquisition Strategy

California-based Unilab followed the same acquisition strategy as National Health Labs, **Corning/MetPath** and Physicians Clinical Laboratories. Unilab aggressively purchased laboratories during the first half of the 1990s. Unilab, with annual revenues of $200 million, was forced by its auditors to recognize a $70.2 million charge for year end 1996 to align corporate asset values with current market values.

As of December 31, 1996, LabCorp listed intangibles as $891.1 million. Were LabCorp to write down the same percentage of intangibles as Quest, it would use about 40%.

This would generate a write-down of $355 million. Offset against stockholder equity, currently at $258.1 million, LabCorp would end up with a negative net worth approaching $100 million. Obviously such a step would have far-reaching consequences for both LabCorp and the competitive laboratory marketplace throughout the United States.

Speculative Scenario

The scenario described above is speculation. But it is based on projecting the specific actions already taken by laboratory industry competitors and applying the same principles to LabCorp's balance sheet.

Obviously there are a host of legal and financial issues involving this matter which observers outside LabCorp cannot fully understand. However, it is important to understand that this industry-wide trend of revaluing intangibles quantifies the financial devastation experienced by clinical laboratories during the last three years. It presages further restructuring of the commercial laboratory industry which will take place in 1997 and 1998. TDR

(For further information, contact Richard Michaelson at 818-758-6607.)

The Dark Index

LabCorp Struggling To Regain Financial, Operational Balance

CEO SUMMARY: 1997 will be a "make or break" year for Laboratory Corporation of America. The company is challenged on many fronts. As LabCorp's management focuses on internal issues, nimble laboratory competitors have an opportunity to capture additional market share.

STABILITY CONTINUES to elude **Laboratory Corporation of America**. Wracked by a variety of setbacks over the last 12 months, LabCorp is working feverishly to regain financial and operational balance.

On one hand, LabCorp must address financial issues to the satisfaction of its lenders. On the other hand, LabCorp must continue to revamp operations and deal with changes to the clinical laboratory marketplace.

> ***A careful study of LabCorp's situation reveals three basic problem areas which need resolution...***

This creates a dichotomy for LabCorp within the competitive marketplace. At the regional level, LabCorp employees continue to service clients on a daily basis. Clients and laboratory competitors see few visible signs of problems.

But internally, LabCorp's management team is preoccupied with solving the financial and operational problems now facing the company. This handicaps their ability to bring new services into the marketplace. It also means that senior executives are not giving business development the same daily priority as their competitors.

In the short term, there will be little perceptible change to LabCorp's market position. However, over the next 18 to 24 months, visible market share losses may occur. **Nichols Institute**, during the last three years of its independent existence, underwent the parallel experience which LabCorp is enduring today. Nichols never did solve its business problems and was eventually sold to **Quest Diagnostics Incorporated** (formerly **Corning/MetPath**).

A careful study of LabCorp's situation reveals three basic problem areas which need resolution: 1) capital, credit and net worth; 2) operational concerns; and 3) employee morale.

ISSUE NUMBER ONE
Capital, Credit & Net Worth

Since the merger between **National Health Laboratories** and **Roche Biomedical Laboratories** became effective in the spring of 1995, LabCorp's financial position has steadily eroded.

One measure of that deterioration is stockholder equity. As of December 31, 1995, stockholder equity was $411 million. By December 31, 1996, it had shrunk to $257 million. Although most of this relates to the $189 million settlement with the federal government, during 1996 LabCorp experienced declining operating profit margins common to the laboratory industry.

LabCorp's financial deterioration during the second half of 1996 caused its lenders to become concerned. Lender concern was heightened when it was recognized that LabCorp did not have the $189 million in cash to pay the federal settlement. LabCorp was forced to borrow the money from a subsidiary of **Roche**.

Pressing Problem

As a result, LabCorp's most pressing problem is probably now with their lenders. Since violating debt covenants last summer, the company has signed at least six waivers with its creditors.

As of December 31, 1996, the company had $998 million in debt. It is now classified as "current" on LabCorp's balance sheet, which means that it is expected to be repaid (or refinanced) within 12 months. LabCorp's lenders are disquieted and it is easy to see why. Bankers are uncomfortable with the fact that only $258 million of net worth backs LabCorp's $998 million debt!

LabCorp's solution to their money woes is to raise $500 million by offering 10 million shares of convertible stock to the public. Since the company's common stock now trades at $3.00 per share, LabCorp would dilute existing stockholders if it issued additional shares of common stock.

What is interesting about the $500 million offering is that Roche, LabCorp's parent company, committed to purchase $250 million worth of shares. Because the proceeds will be used to retire the $189 million loan from the Roche subsidiary, Roche is basically paying themselves back.

However, Roche's actions are seen by Wall Street investors as a sign that Roche will not allow LabCorp to fail. Stock analysts tell THE DARK REPORT that investors believe Roche will stand behind LabCorp with deep pockets.

It remains to be seen whether LabCorp's $500 million stock offering is fully subscribed. If investors take all of the offering, it means that LabCorp's executives will have kept the creditors

Interesting Fact:

Why Hospital Alliances Are A Slow-Growth Strategy

LabCorp, like Quest and SmithKline, made hospital alliances and joint ventures a major corporate priority. As a result, hospital laboratory administrators receive a continual stream of sales calls from marketing reps of the three national labs.

But how successful have these laboratories been after three years of concentrated effort? LabCorp's financial documents provide a revealing look at the results:

> **"One of the Company's primary growth strategies is to develop an increasing number of hospital alliances... In 1996, the Company added 6 alliance agreements with hospitals, physician groups and other care provider organizations representing approximately $20 million of annual sales which increased the total number of alliances to 20 from 14 in 1995."**

This is a revealing statement. LabCorp, with $1.6 billion in annual revenues, added 6 hospital laboratory alliances representing $20 million, and only has a total of 20 active alliances. For 1996, the average new alliance generated $3.34 million in revenue to LabCorp.

With 20 alliances outstanding, that projects to be about $67 million, or 4.2% of LabCorp's $1.6 billion in sales. LabCorp's experience is not dissimilar to that of Quest and SmithKline. It means that after three years of intense, and expensive, marketing, the three national labs have not gained much market share with hospital laboratory alliances.

away from their door for at least some period of time.

ISSUE NUMBER TWO
Operational Concerns

Like its two national competitors, LabCorp continues to pursue the economies of scale which they believe their national laboratory system provides them. This means consolidation, standardization and unification throughout the national system, regardless of regional needs or local marketplace preferences.

Many of these corporate initiatives have not gone smoothly. For example, during the first quarter of 1997, LabCorp had difficulty submitting reimbursement claims to Medicare. At one point it was rumored that 38% of the company's Medicare claims were denied at first submission.

This created havoc with LabCorp's "days sales outstanding" ratio, reported to have risen to as much as 120 days. It directly affected LabCorp's cash flow at a time when every dollar was needed.

The company attempted to centralize billing from all regions into one location. When the project failed to deliver satisfactory results, billing was returned to the regions. Experienced laboratory executives know that billing problems are a major source of lost clients. Because it takes several months for lost client patterns to appear, it will be interesting to watch LabCorp's financials for first and second quarter 1997 to see if the company experienced significant client turnover.

At the regional level, competing laboratories report a variety of operational or strategic difficulties by the LabCorp divisions in their area. These are understood to be the result of regular waves of staffing cutbacks and the closure of satellite laboratories. Pullbacks of local resources which affect client service, such as stat labs and phlebotomy stations, also have a negative impact on client service levels.

With senior management in Burlington preoccupied with financial problems, it means that operational issues are not receiving the same degree of attention as would be true in a normal operating environment.

ISSUE NUMBER THREE
Employee Morale

LabCorp, along with Quest and **SmithKline Beecham Clinical Laboratories**, has been implementing different waves of staff cutbacks during the last two years. This has a major impact on employee morale. It is particularly damaging because surviving employees are uncertain whether or not they may be laid off whenever future staff cutbacks occur.

LabCorp was also forced to take another difficult step last summer. After reporting a loss for second quarter 1996, the company implemented a six-month deferral on wage rate increases. Traditionally, such a maneuver devastates employee morale and loyalty.

Adding to employee uncertainty is the regular departure of senior executives since the merger. As Roche executives prevailed in the game of corporate politics, many executives from National Health Labs either resigned or were cut loose. Not only has this engendered bad feelings among employees loyal to the departed managers, but it creates turmoil while new managers transition into their responsibilities.

LabCorp's employee morale is a major problem because it prevents the company from attaining high levels of quality and service. Until the financial situation is resolved, morale will probably not improve.

These three serious problems within LabCorp must be resolved before the company can regain financial health and restore operational stability. Thomas Mac Mahon, LabCorp's new President and CEO, faces a daunting task to turn things around. TDR

Laboratory War College To Highlight Innovation

Management event features advanced techniques for lab consolidation and regional lab networks

CEO SUMMARY: Quickly establishing itself as the premiere event for the management of clinical laboratories, this year's Executive War College in New Orleans offers specialized advice and experience for laboratory administrators. Expect to hear the first public presentations about innovative discoveries which lower costs and boost laboratory performance.

SPECIAL PRESENTATIONS scheduled for this year's *EXECUTIVE WAR COLLEGE* in New Orleans on May 20-21 will bring first news of several exciting innovations for pathologists and laboratory administrators.

As listed in the February 17 issue of THE DARK REPORT, eight case studies of innovative laboratory consolidations and regional lab networks will be presented. These case studies are complemented with an extensive range of specialized programs.

Candid Case Studies

"We do two things at the *EXECUTIVE WAR COLLEGE*," stated Robert Michel, Editor In Chief of THE DARK REPORT and producer of the program. "First, we present case studies of innovators in lab consolidation and networking. These are candid discussions of the management strategies used. Successes and setbacks are openly shared, and usually this generates lively give-and-take between speaker and attendees.

"Second, our breakout sessions focus on specialized management topics necessary to support a laboratory consolidation or regional network," continued Michel. "These are individuals or vendors actively and successfully involved with an operating network or consolidation.

"For example, last year we had **Advanced Laboratory Group** detail how they built a single-entry LIS system which connected the 40 hospital laboratories in Pittsburgh's **Reference Laboratory Alliance** network," observed Michel. "To my knowledge, that is still the only single-entry, multiple-hospital laboratory information system that linked together an operating regional laboratory network.

"This year Dr. Patrick James, Director of Pathology and Clinical Laboratories at **Health MidWest** in Kansas City, will discuss how they converted eight hospital laboratories to a single LIS *before* they proceeded with the laboratory consolidation," explained Michel. "According to James, the LIS conversion not only accelerated the actual laboratory consolidation process, but it had the unexpected benefit of building communication among the separate pathology groups in the system."

First news about the effectiveness of "random-test/random access" instruments will be delivered by Ron Wagener, Ph.D., Laboratory Director at **Laboratory Corporation of America's** Louisville facility. Wagener's team used **Roche's** new Integra instrument to reengineer his laboratory's workflow. A total of 17 instruments were replaced by one Integra. Substantial cost savings resulted, as well as improved quality and turnaround times for test results.

On the pathology front, David Rabbitts will provide examples of how pathology compensation agreements are being renegotiated with hospitals in different parts of the country. Rabbitts is Administrator, Laboratory Systems at **Weusthoff Health Systems** of Rockledge, Florida.

Managed Care Contracts

Managed care contracting strategies and techniques get full attention at this year's *Executive War College*. Four presentations will cover vital aspects of how to *profitably* bid and service managed care contracts.

Christian Haller, Senior Healthcare Analyst at **Finger Lakes Blue Cross/Blue Shield** in Rochester, New York will present the insurer's prospective. For the laboratory perspective, Robert Collier, Vice President of Marketing and National Accounts at **American Medical Laboratories** in Chantilly, Virginia will reveal techniques his lab has used to keep contract capitation rates above $1.00 PMPM.

One hot topic these days is utilization review, test algorithms and clinical interaction between laboratories and clinicians. For eight years **St. John's Hospital** laboratory in Tulsa, Oklahoma has maintained a successful program of applying laboratory data to clinical processes and outcomes. Terrance Dolan, M.D., Chief of Pathology at St. John's, will describe the infrastructure needed to collect laboratory data, as well as the practical dynamics of getting clinicians to respond to laboratory information and outcomes data.

"There is one interesting development which demonstrates the practical management value that the *Executive War College* has for attendees," noted Michel. "As of this early date we have 17 hospital laboratory systems which registered multiple attendees. They tell us that they are using this as a 'strategic retreat.' Instead of sending one person to attend and report back to their management team, they are sending several key decison makers.

"Their objective is learn from the presentations as a team, then debate the merits of the management lessons among themselves over the course of the two days," he explained. "This is consistent with the feedback we heard from groups who attended last year's *Executive War College*, where the same phenomenon occurred"

Early registrations for this year's *Executive War College* exceed those of last year. Those planning to attend should not delay, since New Orleans is a busy destination city and hotel rooms will be at a premium during War College Week. **TDR**

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

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Quest Diagnostics Incorporated reported quarterly earnings last week. It is the first look at the financial performance of the newly-independent spin off from **Corning Incorporated**. The company reported net income of $4.0 million on revenues of $388.1 million. Revenues declined 3.3% from same quarter last year. This indicates that revenue erosion still continues.

MORE ON: Quest Diagnostics Incorporated...
Although revenues declined from the same quarter last year, Quest indicates that pricing improved 1.6% above last year. Quest attributes this to improved pricing discipline (long lacking among the national laboratories) and contract renegotiations.

ADD TO: Pricing Discipline...
Laboratory Corporation of America reported that pricing was stable for fourth quarter 1996, the second consecutive quarter this occurred. Combined with Quest's experience, it could be an early sign that major laboratories are finally learning how to avoid "loss leader" pricing.

Is **Neuromedical Systems, Inc.**, maker of the PapNet® System, being picked on or simply getting their just desserts? On March 31, **NeoPath Inc.**, maker of the AutoPap® System, sued Neuromedical on claims of patent infringement. Neuromedical was then hit with another lawsuit on April 15. **Cytyc Corporation**, maker of the ThinPrep® System, sued Neuromedical and **PIE Mutual Insurance Company**. Cytyc alleges, among other things, deceptive trade practices, unfair competition and defamation.

ADD TO: Neuromedical...
DARK REPORT readers know that Neuromedical started this feud back on July 15, 1996. At that time Neuromedical sued NeoPath on the grounds of patent infringement, false advertising, and unfair competition. Maybe it is time for *all* the companies in the automated cytology market to compete in the marketplace, not in the courts. In the long term, the marketplace is always an efficient judge of product quality and a company's integrity.

HMO Both **Laboratory Corporation of America** and **SmithKline Beecham Clinical Laboratories** announced the signing of national contracts with **United Healthcare**. Both laboratories are now preferred providers for laboratory services. United Healthcare is the largest public managed care company. It has 5.12 million members in its HMO plans.

Impath Inc. attracted favorable attention on Wall Street. Last week **Prudential Securities** launched coverage of the disease management company. Analyst Ken Bohringer rated Impath a "buy." Impath is one of an emerging group of boutique companies combining laboratory and pathology testing with disease management services for clinicians.

MYSTERY BUYER

Look for a big announcement about the sale of a respected independent laboratory. Laboratory industry observers will be surprised at who the buyers are, as well as the source of the acquisition funds.

That's all the insider intelligence for this report. Look for the next briefing on Monday, May 12, 1997

THE DARK REPORT

UPCOMING...

- Inside Look At The "New Laboratory" Model Directed At Disease State Management.
- Update On State Regulatory Initiatives Which Handcuff Clinical Laboratories.
- Regional Laboratory Networks Come Of Age: Successes And Setbacks For 1997.
- FDA Regulation Of Laboratory Information Systems Is Around The Corner.