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From the Desk of R. Lewis Dark...

THE DARK REPORT

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

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R. Lewis Dark

Founder & Publisher

Where Do We Go From Here?

THIS IS WRITTEN FOR BOTH LABORATORIANS COMING TO THE DARK REPORT'S *Executive War College* in New Orleans next week as well as those not attending. As I look at the registration list, I see a diverse range of attendees.

Registered for this year's event are CEOs of public laboratories and owners of independent commercial laboratories. Hospital laboratory administrators and directors from some of the nation's largest integrated delivery systems will attend, along with those of rural hospitals. From the leading instrument manufacturers and LIS vendors, national sales and marketing directors, product development people, and regional sales managers will be in New Orleans. An interesting range of people from the three national laboratories plan to show up as well. I know that a similar cross section of influential industry executives are clients and regular readers of THE DARK REPORT.

This is an excellent and high-quality group of laboratory executives. To them all and those of you reading this, I pose a question: Where do we go from here? Given the turmoil in the clinical laboratory industry since 1994, does anyone have a clear picture of what type of laboratory organization is the success model for the future? I ask these questions for an excellent reason.

The clinical laboratory industry has never been good at predicting its future. Many industries regularly convene forums with the sole objective of exploring the future. When the trends acting upon a profession are understood, it is easier to plan effective business strategies. But to my knowledge, the clinical laboratory industry has never arranged such an event.

Because of the parochial interests of our industry, large commercial laboratories have traditionally "done their own thing" in isolation from the rest of the industry. Meanwhile, hospital-based laboratorians considered any commercial laboratorian as an enemy, usually to be scorned. Their attention was focused on the needs of the hospital they served. As to the laboratory industry vendors, it is difficult to maintain good relations with all segments of the laboratory industry, let alone volunteer to bridge this traditional gulf.

So back to my question: where do we go from here? I think it is time for our industry to unite its separate factions for the worthy goal of exploring the future. The capability to start this process exists with the excellent cross-section of lab industry leadership coming to New Orleans for the *Executive War College*. Will anyone take up my challenge? I certainly hope so, because our industry needs its leaders to focus their collective wisdom on solving the intractable problems which lie ahead. TDR

A Fable For Our Times: Lab Industry's Golden Era

Good times are past and gone, replaced by constant change, risk, and uncertainty

CEO SUMMARY: The clinical laboratory industry's "Golden Era" is gone forever. Replacing it is a healthcare environment best described as "Darwinian." It is now survival of the fittest, as hospital laboratories and commercial laboratories struggle to reinvent themselves. Case studies at this year's Executive War College can be considered adaptive mutations spawned in response to marketplace trends.

ONCE UPON A TIME, the clinical laboratory industry was admired far and wide as a stable, profitable business. Each year, as predictable as clockwork, hospital laboratories and commercial laboratories earned sizeable profits.

During this golden time, employment stability was considered to be a birthright. It was almost the norm for medical technologists to work ten, 20, even 30 years at the same laboratory. The daily routine was predictable and even boring.

Pathologists found easy opportunities to expand their incomes. Hospital contracts were generous and the work pace was predictable. With small investments, pathologists could start clinical laboratory operations which quickly became profitable and grew steadily, almost without effort.

It was a time of abundance, even ease. Little changed during this golden time and laboratory managers found it simple to keep their laboratories running like a finely-tuned machine.

But with unexpected suddenness, this golden era ended. Managed care arrived on the scene. Concern about fast-rising medical costs brought a tidal wave of change to healthcare. The clinical laboratory industry was probably the first segment of the healthcare marketplace to find itself going broke.

Lulled by the easy times of the golden era, laboratory executives were unprepared for the tidal wave of change which engulfed them. Almost overnight, fat profits evaporated.

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

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

Losses quickly grew to astronomical size. The government discovered that laboratories were biting the Medicare hand that fed them. Investigations for fraud became widespread.

The end of the golden era for clinical laboratories brought widespread layoffs. The birthright of employment stability was stripped away, replaced by ongoing, predictable cutbacks to staff. Cost reduction became paramount because of the continuous year-to-year decline in the reimbursement for laboratory tests.

It is accurate to say that the once-calm world of clinical laboratories has turned Darwinian. Now it is survival of the fittest. There is brutal competition between laboratories. Lab managers find themselves being required to lay off long-time co-workers, downsize facilities, and consolidate testing among numerous sites. There is unrelenting pressure to continuously reduce costs.

For pathologists, changes have been just as disruptive. Hospital mergers, acquisitions, and alliances have altered long-standing compensation arrangements. Consolidation of pathology practices is a growing trend, bringing with it dramatic changes to lifestyle, working arrangements, and income.

Fable For Our Time

This is the fable for our time. Its truths are apparent to anyone familiar with these events. As recently as 1994, most public laboratories reported acceptable profits. It took only three years for these remarkable changes to ripple through the marketplace.

As fat profits of the golden era disappeared, laboratories struggled to find ways to operate in the black. Executives in both hospital labs and commercial labs were unprepared to meet the challenges wrought by managed care.

Deterioration to the financial health of laboratories has converted the marketplace into a Darwinian free-for-all. It is now survival of the fittest. Laboratory executives who correctly interpret market trends, develop effective strategies, and implement them nimbly are surviving. But laboratory executives must do all three, or their laboratories will perish.

Which brings me to the point of this article. It was *old* knowledge and *old* philosophies which made laboratories successful during the golden age.

But today's world requires that laboratory managers acquire *new* knowledge, *new* skills, and *new* perspectives on clinical laboratory operations. Today's world requires a different kind of laboratory manager. This new manager must combine a different operating philosophy with sophisticated management skills for managing people, processes, finances, and assets.

Lab Executives Need Industry "Think Tank"

"Given all the changes occurring to healthcare and the laboratory industry," said Mark Smythe, Principal of **Management Mentors** in Wilsonville, Oregon, "it is time for the industry to develop a 'think tank.'

"I do not yet see a source of believable management information and information within the clinical laboratory industry," he continued. "The closest thing I have seen is THE DARK REPORT's *Executive War College.* It is one place where I find a strong emphasis on essential management issues and techniques.

"At the same time, I have searched to find a regular place where I can personally network with laboratory managers and pathologists who see the world as I do," noted Smythe. "My greatest source of learning comes from meeting laboratorians who are successful. *The Executive War College,* with its distinctive mix of laboratory leaders, is one such place where I connect with fellow travelers.

"It is important for our industry to develop a 'think tank' for laboratory management," concluded Smythe. "I encourage both THE DARK REPORT and *War College* attendees to tackle that problem."

Today we recognize how the golden era of fee-for-service and fat profits failed to teach today's crop of laboratory executives and managers the lessons they needed to survive managed care. In that respect, the laboratory industry lags behind other industries where disruptive change has already occurred. For example, the auto industry of the 1970s underwent radical transformation through the 1980s. It has only regained consistent profitability during the 1990s.

Corporate Management

Healthcare is a multi-billion dollar cottage industry now undergoing transformation into corporate management forms. It is critical for laboratory managers and executives to realize that the success of their careers, and their laboratory organization, depends on their ability to understand and act upon this fact.

Acquiring that knowledge is one major goal of THE DARK REPORT's annual *Executive War College*. Each year this program identifies winning laboratory organizations and invites them to share their management strategies, tactics and performance with *War College* attendees. The objective is to identify what works in today's healthcare marketplace and share that knowledge with those in attendance.

If you ascribe to Darwin's theories about evolution, then many of our *War College* case studies represent adaptive mutations that are fundamentally unlike most laboratory organizations. These mutant laboratories enter the marketplace with different characteristics. Such differences give them a competitive advantage. It sets them apart form other clinical laboratories.

Since all organizations are comprised of people, these mutations are different in one essential characteristic. They have executive leaders with a distinct view of the world and a different set of management tools.

It is the goal of *War College* case studies to identify these leadership differences and make them visible to attendees. Our faculty strives to define the management strategies, tools and techniques used to vigorously pursue the business plan of that mutated laboratory organization.

In that respect, the *Executive War College* is becoming the laboratory industry's "think tank." (See sidebar on page 3). Our industry needs a resource where senior laboratory executives can attend a meeting, interact with his or her peers, learn advanced and innovative management initiatives, and network with intriguing people.

When this year's *Executive War College* convenes in New Orleans on May 12-13, it will be the third time in as many years that several hundred senior-level laboratory administrators and executives have gathered to acquire advanced knowledge about clinical laboratory management.

Future Of The Industry

Each year, this program attracts the type of laboratory executive who is shaping the future of the industry. Both faculty and attendees are experimenting with new ways to organize and operate laboratories. They come with a common interest to learn about what works and to identify what doesn't.

Remember our fable about the golden era of clinical laboratories? The golden era may be over, but healthcare's need for accurate and sophisticated diagnostic testing is increasing.

A new "golden era" for clinical laboratories approaches. This demand for effective diagnostic services will drive the industry forward. Case studies and Faculty at this year's *Executive War College* will provide the earliest clues as to how laboratories can restructure themselves for the future of healthcare. TDR

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

Commercial Lab Values Validated By Recent Sales

Owners of clinical laboratories find prices offered by buyers reflect changed market

CEO SUMMARY: Many current owners of independent laboratories now wish they had sold during the glory days of commercial laboratory acquisitions. Recent sales transactions demonstrate that current market valuation for clinical laboratories is based on actual cash flow. Even at these new valuations, there are few buyers.

OWNERS OF INDEPENDENT LABORATORIES who want to sell their business face two big obstacles. First, there are few or no buyers. Second, prices to be paid are considerably reduced from the peak pricing levels seen during 1993-94.

From a consistent high valuation during 1993-94 of 1.0 to 1.25 times annual net revenues, commercial laboratory prices have spiraled downward. Current valuations are primarily based on a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization). The few market transactions which took place indicate laboratory values currently range about 0.5 times annual revenue.

In the last issue of THE DARK REPORT *(April 13, 1998)*, it was noted that **Bio-Reference Laboratories, Inc.** (BRLI) was paying not over $7 million to acquire MediLabs, Inc. of Valley Cottage, New York. MediLabs is a $14.7 million operation, so BRLI was getting MediLabs for under 0.5 times net revenues.

Since 1994, only a limited number of independent laboratories have successfully sold themselves. In April, **Laboratory Corporation of America** made the news when it announced an agreement to purchase **Medlab, Inc.** of Wilmington, Delaware.

Medlab is a $20 million laboratory currently in Chapter 11 bankruptcy proceedings. It filed for bankruptcy protection in September 1997 and has been unable to develop a satisfactory reorganization plan.

> ***"Remember that, as recently as 1994, a clinical laboratory could be sold for 1.0 to 1.25 times annual earnings. Today, most clinical laboratories will be offered a purchase price closer to 0.5 to 0.7 times annual revenue."***
>
> **Christopher Jahnle**
>
> *Director, Haverford Healthcare Advisors*

Terms of this purchase were not announced and the only reference made about details was that LabCorp would "acquire certain of the assets of Medlab." That probably means that LabCorp will purchase the client list plus specific tangible assets that LabCorp finds useful.

In May 1997, **Quest Diagnostics Incorporated** acquired **Diagnostic Medical Laboratories** (DML) of Branford, Connecticut. At $30 million in annual revenue, DML was the largest independent laboratory then remaining in Connecticut. As in the Medlabs transaction, Quest did not reveal specifics about the purchase price and terms. *(See TDR, June 23, 1997.)*

However, DML was located close to Quest's regional laboratory in nearby Wallingford. The unusual combination of attractive purchase price, natural opportunities for local consolidation and the acquisition of a major competitor motivated Quest to complete this acquisition. It should be noted that Quest Diagnostics has stated publicly that it will not do acquisitions as a normal course of business.

Laboratory Transaction

Probably the only other major laboratory transaction which occurred within the last three years is the sale to private investors of **American Medical Laboratories** in Chantilly, Virginia. *(See TDR, May 12, 1997.)* AML does about $60-70 million per year in revenue. It was known to be financially strapped, and the price paid to AML's owners reflected a low multiple of annual revenue.

The limited number of clinical laboratory sales indicates several things. First, there are only a few potential buyers. Financial problems of the clinical laboratory industry are well-known and discourage outside investors.

Second, in almost every instance, the successful buyer is someone in a unique position to benefit from the laboratory assets being offered for sale. This usually means the buyer already operates in the same geography as the lab to be sold.

Third, EBIDTA is now the stronger measure for determining value, not annual revenues. This means that laboratory owners should concentrate on improving operating income and net earnings if they want to receive a higher sales price.

Because a sizeable number of independent laboratories still operate in the United States, the issue of purchase price and terms will continue to be closely watched. Every consummated laboratory sale becomes an important indicator of actual market values. TDR

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

Formula For Intangibles Reflects Today's Values

*When **Corning Clinical Laboratories** was spun off into Quest Diagnostics on December 31, 1996, it was necessary to recast the balance sheet to reflect current market values.*

*"Intangibles" was the accounting entry used to reflect the excess of purchase price over assets when Corning (previously known as **MetPath**) acquired clinical laboratories. Corning had paid multiples of 1.0 to 1.25 times annual net revenues to buy these laboratories.*

Given the precipitous decline in the financial health of the industry by early 1997, Quest chose to write down its $1.030 billion of intangibles by $455 million. Per company filings, "management's estimate of fair value is currently based on multiples of revenue primarily ranging from 0.5 to 0.7 times revenue and on multiples of EBITDA primarily ranging from five to six times EBITDA."

Quest's valuation formulas closely reflect prices paid in the limited number of actual laboratory sales transactions which occurred in 1997-98.

Public Laboratory Standings

GENERAL REFERENCE LABORATORIES

1997 Ranking By Annual Revenue
($s in millions)

Rank	Laboratory	Annual Revenue
1.	Quest Diagnostics Incorporated	$1,530
2.	Laboratory Corporation of America	$1,520
3.	SmithKline Beecham Clinical Laboratories	$1,390
4.	Unilab, Inc.	$214
5.	Lab*One*, Inc.	$79
6.	DIANON Systems, Inc.	$61
7.	Universal Standard Healthcare, Inc.	$56
8.	Bio-Reference Laboratories, Inc.*	$38
	Total: General Reference Laboratories	***$4,888***

**Fiscal year ending 10/31/97*

Comments About These Rankings:

These rankings are based on the laboratories' financial performance for 1997. They illustrate how much change has occurred to the clinical laboratory industry.

The table above includes those laboratories considered to offer a general range of testing. In most cases, these laboratories have been in operation since 1980 or earlier.

The table below includes laboratories considered to be boutique, or niche, laboratories. What is common to each is their focus on a narrow segment of the market for diagnostic testing.

One interesting characteristic of these niche laboratories is that almost all of them were established since 1990. They are a response to recent healthcare trends.

BOUTIQUE/NICHE LABORATORIES

1997 Ranking By Annual Revenue
($s in millions)

Rank	Laboratory	Annual Revenue
1.	Impath, Inc. *(oncology)*	$37.1
2.	UroCor, Inc. *(urology)*	$33.0
3.	PharmChem, Inc. *(substance abuse)*	$39.2
4.	Laboratory Specialists of America, Inc. *(substance abuse)*	$12.8
	Total: Boutique/Niche Laboratories	***$122.1***

1997 LIS Sales Rankings Topped By Cerner, LabSoft

Cerner outsells Meditech in hospital segment, LabSoft repeats in commercial lab market

CEO SUMMARY: Consolidation in the LIS industry continued during 1997. The impact for laboratory buyers is that market share is concentrated among fewer vendors. Over the long term, this reduces choice and leads to an oligopoly-type of market. In the short-term, all LIS companies are competing aggressively to build market share.

DURING 1997, **Cerner Corp.** toppled **Meditech** as the sales champ for new sales of LIS to hospitals in THE DARK REPORT's annual ranking of the *Top Ten LIS Vendors*. **LabSoft, Inc.** was first in the commercial laboratory category for the second consecutive year.

Rankings for 1997 reveal how consolidation among LIS vendors is concentrating control of the marketplace in the hands of a limited number of companies. Three firms now control half of hospital LIS systems in the United States. Market concentration in the non-hospital (commercial) laboratory category is even more extreme, with three companies controlling two thirds of the total marketplace.

Cerner sold 203 new laboratory information systems to hospitals in 1997. **Sunquest Information Systems** was second, with 102 sales and Meditech ranked third, with 66 new sales. It is these three vendors which now control more than half of the new sales market for hospital-based LIS.

When it comes to installed LIS, Meditech retains its lead, with 1,010 hospitals. Sunquest Information Systems is second and Cerner is third, with 790 and 730 hospitals, respectively. These three companies hold almost 50% of installed hospital LIS software throughout the United States.

Rankings for 1997 reveal how consolidation among LIS vendors is concentrating control of the marketplace in the hands of a limited number of companies.

Meditech led THE DARK REPORT'S rankings in new sales to hospitals for both 1996 and 1997. Its biggest customer is **Columbia/HCA Healthcare** and Columbia was converting each newly-acquired hospital to Meditech.

As Columbia's hospital acquisition program slowed during 1997, Meditech saw a decline in new LIS installations to hospitals owned by Columbia. Meditech's total new LIS sales to hospitals have fallen from 137 (1995) to 82 (1996) to 66 (1997).

In the non-hospital category, LIS sales activity is shifting. LabSoft sold

156 systems, which was almost triple the sales of runner-up **Schuyler House**, which sold 55 systems. **Creative Computer Applications** placed third, with 16 new LIS sales.

LabSoft's excellent sales performance during the last two years gives it the most installations for non-hospital laboratories. LabSoft has 702 systems installed. Next in line is Sunquest Information Systems with 584 LIS installations. Third on the list for 1997 is **CPSI**, with 195 installations.

Sunquest Acquired Antrim

Antrim traditionally dominated the market for commercial laboratory installations. In 1996, Sunquest acquired Antrim. Under Sunquest, Antrim's LIS software continues to be a significant force in the market for commercial laboratories. Antrim's LIS is used by a substantial number of larger commercial laboratories. Because of market consolidation, bankruptcies and other factors, there are fewer independent commercial laboratories in the United States today than five years ago.

Thus it is no surprise that Sunquest is not selling high numbers of LIS to commercial laboratories. In 1997, it was number seven in THE DARK REPORT'S rankings of new sales. But those sales were generally to larger laboratory organizations. It demonstrates that Sunquest's market position among larger commercial laboratory companies continues to be substantial.

The annual rankings of THE DARK REPORT'S *Top Ten LIS Vendors* reveal that significant marketplace changes are altering both the structure of the LIS industry and how it services its laboratory customers.

Each year fewer LIS companies are on the total list of vendors with new sales or installed systems. The primary reason

THE DARK REPORT'S Top Ten LIS Vendors
Hospital Sales (1997)

Rank	Company	New Sales 1997	Cumulative Sales	New Sales Per Cent	Cumulative Per Cent
1	Cerner Corp.	203	203	30.76%	30.76%
2	Sunquest Information Systems	102	305	15.46%	46.22%
3	Meditech	66	371	10.00%	56.22%
4	HBO & Co.-STAR & SAINT	54	425	8.19%	64.41%
5	Shared Medical Systems	45	470	6.82%	71.23%
6	CPSI	22	492	3.34%	74.57%
7	Creative Computer Applications	18	510	2.73%	77.30%
8	LabSoft, Inc.	16	526	2.43%	79.73%
9	Triple G Corporation	15	541	2.28%	82.01%
10	Soft Computer Consulting	13	554	1.97%	83.98%
	Total All (38) Vendors: New Sales	660			100.00%

Provided by: R.L. Johnson & Associates

is acquisition activity. Larger LIS companies are buying smaller competitors.

These smaller competitors usually have innovative technology or high quality LIS products. But small size and a limited capital base handicap them in three ways. First, they lack the resources required to market themselves on an equal footing with larger LIS companies. Second, they lack the capital necessary to continually integrate new hardware and software technology into their LIS product.

Fundamental Rules

The third reason is not obvious, but illustrates how rapidly managed care has changed the fundamental rules of the game. Rapid and non-stop changes to reimbursement guidelines are accompanied by increasing clinical integration. The smaller LIS companies must invest in adapting their software to meet these evolving requirements. Such investment requires more capital than they have available. Because they lack necessary capital, selling to a larger company is frequently the only viable option for the small LIS vendor.

Consolidation of the LIS industry inhibits innovation and entrepreneurial risk-taking from occurring. As smaller, more market-responsive LIS companies are swallowed by the industry leaders, it becomes tougher to create innovative products using cutting-edge technology and introduce them to the marketplace.

Corporate bureaucracy and internal politics common to all large companies tend to stifle such challenges to the status quo. That is why consolidation within the LIS industry constrains both innovation and early adoption of advanced technology.

It is important for laboratory executives to watch developments in

THE DARK REPORT'S Top Ten LIS Vendors
Hospital Installations (1997)

Rank	Company	Total Installed	Cumulative Installed	Installed Per Cent	Cumulative Per Cent
1	Meditech	1,010	1,010	19.60%	19.60%
2	Sunquest Information Systems	790	1,800	15.33%	34.93%
3	Cerner Corp	735	2,535	14.27%	49.20%
4	HBO & Co.-All LIS	425	2,960	8.25%	57.45%
5	Citation Computer Systems	304	3,264	5.90%	63.35%
6	Isys/Biovation	243	3,507	4.72%	68.07%
7	Shared Medical Systems	203	3,710	3.94%	72.01%
8	Soft Computer Consulting	160	3,870	3.11%	75.12%
9	Triple G Corporation	130	4,000	2.53%	77.65%
10	Creative Computer Applications	127	4,127	2.47%	80.12%
	Total All (38) Vendors: Installations	5,153			100.00%

Provided by: R.L. Johnson & Associates

the LIS industry. Information system technology is a major critical success factor for clinical laboratories. If a laboratory has poor LIS product, it will never be competitive in the managed care marketplace.

Most Important Legacy

Whether or not managed care succeeds as the final evolutionary form of healthcare, integrated data system capability will be its most important legacy. Every clinical laboratory must acquire the capability to do five things with information.

First, it must be able to gather laboratory results from a variety of settings, including near patient and point-of-care testing sites. Second, it must warehouse this data so it is accessible and usable in a variety of forms.

Third, the clinical laboratory must be able to use the laboratory test data in the warehouse to create population-wide reports on utilization, outcomes, cost of service, and other information requirements. Laboratories must have the capability to develop value-added services from the information streams generated by the laboratory testing they perform.

Fourth, the laboratory must be able to do sophisticated cost and productivity analysis with the data collected by the LIS. Capitation and other forms of prospective reimbursement now mean that a laboratory which lacks sophisticated cost data will find itself either at a competitive disadvantage or out of business entirely.

Fifth, it will soon be necessary for a laboratory to acquire an LIS product which has process control capability. Process controls are the management tools which the LIS uses to control workflow through the laboratory.

THE DARK REPORT'S Top Ten LIS Vendors
Non-Hospital Sales (1997)

Rank	Company	Total Installed	Cumulative Installed	Installed Per Cent	Cumulative Per Cent
1	LabSoft, Inc.	156	156	50.33%	50.33%
2	Schuyler House	55	211	17.75%	68.08%
3	Creative Computer Applications	16	227	5.17%	73.25%
4	Isys/Biovation	13	240	4.20%	77.45%
5	Computer Services & Support16	11	251	3.55%	81.00%
6	Hex 'FF'	9	260	2.91%	83.91%
7	Intellidata	7	267	2.26%	86.17%
7	Sunquest Information Systems	7	274	2.26%	88.43%
8	New Lab Force	4	278	1.29%	89.72%
9	M/Management	1	279	0.33%	90.05%
9	Psyche Systems	1	280	0.33%	90.38%
	Total All (34) Vendors: Installations	310			100.00%

Provided by: R.L. Johnson & Associates

Process controls speak to the automated instruments and provide operating instructions that maximize work flow throughout the laboratory. *(See TDR, March 31, 1997.)*

That is why selecting an LIS product and vendor is probably the single most important bet a laboratory makes on its future success. At the time the decision is made to upgrade an LIS system or purchase a new LIS product, most laboratory executives do not anticipate how each of the five capabilities listed above will affect the financial stability of their laboratory in the near future.

Additionally, LIS vendors tend to sell their products by stressing their existing strong points. That is human nature. But laboratory executives should give equal attention to LIS product capabilities which are weak. Clinical laboratories need a balanced LIS product capable of providing satisfactory service in each of the five critical areas listed here.

Implementation of an upgrade or conversion to a new LIS product should also get rigorous attention. Anecdotal stories continually reach THE DARK REPORT about LIS conversions which go over budget and totally disrupt the laboratory. This is another area where LIS vendors can show definitive improvement, and where laboratory executives should exercise care when making the final purchase decision for their LIS solution.

Final predictions will conclude this year's rankings: 1) expect to see continued consolidation among LIS vendors; and 2) fewer vendors will hold a larger share of the marketplace. Whether these developments are good or not for the clinical laboratory industry has yet to be determined. **TDR**

(For further information, contact R.L. Johnson at 209-839-8052.)

THE DARK REPORT'S Top Ten LIS Vendors
Non-Hospital Installations (1997)

Rank	Company	Total Installed	Cumulative Installed	Installed Per Cent	Cumulative Per Cent
1	LabSoft, Inc.	702	702	27.50%	27.50%
2	Sunquest Information Systems	584	1,286	22.80%	50.30%
2	CPSI	195	1,481	7.64%	64.17%
4	Isys/Biovation	159	1,640	6.23%	69.11%
5	Schuyler House	126	1,766	4.94%	73.70%
6	Hex 'FF'	117	1,883	4.59%	77.50%
6	New Lab Force	99	1,982	3.88%	80.40%
8	Computer Services & Support	72	2,054	2.82%	82.75%
9	HBO & Co.-All LIS	60	2,114	2.35%	77.84%
10	Soft Computer Consulting	38	2,152	1.49%	84.25%
	Total All (34) Vendors: Installations	2,553			100.00%

Provided by: R.L. Johnson & Associates

Lab Industry Briefs

TENET AND MEDPARTNERS CONTINUE TIGHTENING THEIR SO. CALIF. ALLIANCE

Remember THE DARK REPORT's prediction that **Tenet Healthcare Corp.** and **MedPartners, Inc.** would use their initial alliance to further move towards an integrated clinical relationship? *(See TDR, July 14, 1997.)*

It didn't take long for the two companies to expand their partnership. Early last month, Tenet and MedPartners announced that MedPartners would close its **Friendly Hills Regional Medical Center** (FHRMC) in La Habra by May 15, 1998. The 116,000 patients served by that facility will instead be served by two Tenet hospitals in nearby Whittier and Placentia.

Further, Tenet will purchase the movable assets of FHRMC. Both companies will share risk in caring for the 116,000 patients. An additional 45,000 patients in MedPartner clinics in West Los Angeles and the San Fernando Valley will also be included in this arrangement.

Within southern California, Tenet operates 32 hospitals. MedPartners has 4,000 physicians in the same area, serving 1.4 million patients. MedPartners' HMO, **Pioneer HMO,** now uses Tenet hospitals exclusively. These arrangements were announced last April.

Tenet's management strategies for its 32 hospitals in southern California demonstrate a new model for how a for-profit hospital operator can build an integrated clinical services capability. Tenet is currently consolidating laboratory services at the 32 hospitals, using **SmithKline Beecham Clinical Laboratories** as the consultant and implementer in the project. *(See TDR, November 17, 1997 and January 19, 1998.)* Expect to see further developments with Tenet's 32 hospitals in southern California.

SMITHKLINE LABS OFFERS NEW TWIST TO TESTING FOR DRUGS OF ABUSE

To distinguish itself from other laboratory competitors, **SmithKline Beecham Clinical Laboratories** (SBCL) announced a new capability in drugs of abuse testing. SBCL will now offer to test for nitrate adulterants as well as drugs of abuse on the same specimen.

The new test service is called Test Sure™. Employers will need to specify in advance that they want the adulterant test performed. Potassium nitrate is the most common adulterant, due to a widespread belief that it prevents a positive drug test result. Currently when a laboratory encounters adulterants, it labels the specimen as "unfit for testing." At the request of the employer, SBCL will now report the results of the drug screen and whether nitrites were present in the sample.

In offering this new service, SmithKline has figured out a way to add value to a drug screen, and get paid more for the service. This demonstrates how laboratories can create new services which have extra value over existing products.

AMERIPATH BEEFS UP ACQUISITION CREDIT LINE

AmeriPath, Inc. of Riviera Beach, Florida continues to move ahead of its competitors in the race to build a successful pathology-based physician practice management (PPM) company.

Last week the company announced agreement on a $200 million revolving credit facility with a bank syndicate anchored by **BankBoston** and **Nations Bank.** This new credit line is a sizeable increase to the company's war chest. It will permit AmeriPath to continue its aggressive acquisition of pathology practices.

AmeriPath is using the new credit package to refinance its existing bank debt of $81 million. The remaining $119 million credit line is available for AmeriPath to fund pathology practice acquisitions.

Pathologists should note that the remaining credit line is 150% more bank borrowing power than it used to build up its current system of 18 pathology practices and 145 pathologists. It should be expected that AmeriPath will not hesitate to use this expanded war chest to pursue high profile pathology practices which it wants to acquire.

In a separate announcement last week, AmeriPath reported first quarter earnings. Company revenues were $38.0 million. Income from operations was $8.6 million and net income was $3.8 million ($0.12 per share). These numbers were substantially above those of first quarter 1997.

Significantly, the company reported that "same practice" revenues for first quarter 1998 versus first quarter 1997 were up 14%. "Same store" growth is a concern for Wall Street analysts who follow the company.

Higher Medicare reimbursement accounted for 2-3% of the increase. Approximately 7%, or half of the increase, was attributed to the additional **SmithKline Beecham Clinical Laboratory** contract in Florida. This contract was formerly held by **Pathologists Reference Laboratory** (PRL) of Tampa. The loss of this anatomic pathology contract, and its associated revenues, was a contributing factor in PRL's subsequent sale to **DIANON Systems, Inc.** in January. (*See TDR, March 2, 1998.)*

QUEST DIAGNOSTICS PAYS $6.8 MILLION TO SETTLE WHISTLEBLOWER SUIT

Last month **Quest Diagnostics Incorporated** agreed to pay the federal government $6.8 million to settle a *qui tam* lawsuit alleging that it billed Medicare and Medicaid for tests without proper physician authorization.

The lawsuit was originally filed by Donna Dorer, formerly an employee of Quest's Rockford, Maryland laboratory facility. Dorer was awarded $1.5 million of the settlement for her efforts.

The allegations involved improper billings from 1989 through 1997 at six Quest laboratory sites: Rockville, MD; Baltimore, MD; Teterboro, NJ; Detroit, MI; and Horsham, PA. The $6.8 million represents twice the loss incurred by Medicare/Medicaid, plus penalties of about $3 million for violating the False Claims Act.

Laboratory executives should note an interesting aspect of this settlement. Quest Diagnostics Incorporated signed a compliance agreement with the federal government. It has worked diligently to improve compliance since it paid its first settlement agreement in 1993 (as **MetPath**). Yet, despite these efforts, a whistleblower was able to identify non-compliance on billing procedures within Quest involving claims as late as 1997.

This indicates that laboratory executives should continue to consider whistleblowers within their own laboratory as a serious possibility.

More importantly, it means that laboratory executives should carefully listen to employees who identify billing and compliance procedures they believe are inappropriate. It is a lot easier to evaluate and correct the problem through internal efforts than to endure an investigation by the federal government and pay a settlement involving multiples of the inappropriate billings, plus a large penalty. **TDR**

The Dark Index

National Labs Show Improved Finances For First Quarter, 1998

FIRST QUARTER FINANCIAL performance of the three national laboratories indicates that they may finally be past the worst of the managed care storm.

On April 14, **Quest Diagnostics Incorporated** became the first of the three blood brothers to release earnings. First quarter revenues declined 5.2% from the previous year. But earnings per share increased from $0.14 last year to $0.21 and this is the number most closely watched by investors.

The revenue decline was expected. It resulted from Quest's corporate strategy of repricing existing accounts to profitable levels. Otherwise Quest has stated that it would walk away from unprofitable business.

Money-Losing Accounts

Quest saw a decrease in test requisitions of 8.1%, but net revenue only declined by 5.2%. That is evidence that Quest correctly identified money-losing accounts while keeping the more profitable business. Further validation may be the fact that Quest's average net revenue per requisition actually increased by 3.1% over last year. As it drops unprofitable clients, Quest improves the profitability of existing business. *(See TDR, June 2, 1997.)*

Quest Diagnostics' net revenues of $367.9 million for the quarter give it an annual run rate of $1.47 billon. This is a significant reduction from the $1.7 billion that Quest generated just a few years ago. But, despite a decline of $20.2 million in revenue from the same quarter last year, Quest was able to shave expenses by $24.8 million. Again, this disproportional gain in cost savings over revenue loss demonstrates that Quest is making progress in restoring financial balance to its business operations.

Growth At SmithKline

SmithKline Beecham (SB) reported earnings on April 21. Corporate revenues increased by 8%. For the first time in several years, revenue growth at **SmithKline Beecham Clinical Laboratories** (SBCL) was similar to other business groups within SB. Revenues at the laboratory division were up 7%, the same growth rate as the consumer healthcare division. Pharmaceuticals increased 10% over last year.

SBCL's revenues for the quarter were $337 million, which is about 8% less than Quest's $367.9 million. SBCL's annual run rate is now $1.35 billion, compared to Quest's run rate of $1.47 billion. SBCL reported operating profits of $22 million for the quarter. This is a healthy increase of 15% over first quarter 1997.

Different Pricing Strategy

SmithKline's laboratory division is following a different pricing strategy than Quest. Because of this, it shows a different revenue/profit performance than Quest. Like Quest, SBCL is purging or repricing unprofitable client accounts. But it is also willing to acquire incremental new business using marginal cost pricing. That is why SBCL showed a 7% gain in revenue over last year.

Operating profits increased by 15% during the same period, reflecting SBCL's corporate strategy of acquiring new test volumes while squeezing the production side of the business. Anecdotal reports from different areas of the United States indicate that SBCL is still willing to be the "low price" leader to attract new business. That feeds additional specimen volume into its regional laboratories and helps it to lower its overall average cost per test.

Marginal Cost Pricing

Laboratory executives in states such as California observe that SBCL's strategy of bidding new work with marginal cost pricing has another effect in the marketplace: when competing laboratories match those prices to prevent their existing business from going to SBCL, it hinders them from negotiating higher reimbursement at contract renewal time. SBCL's pricing strategy has the effect of denying additional revenues to competing laboratories.

THE DARK REPORT observed two years ago that excess laboratory capacity is what causes marginal cost-based pricing. Every laboratory with extra capacity has an incentive to use marginal cost-based pricing to attract additional volumes of specimens which can fill that excess capacity.

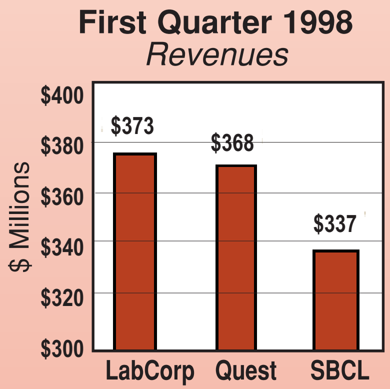
Management Experiment

With SmithKline Clinical Laboratories still willing to use marginal-cost pricing to capture new business, its corporate strategy provides an interesting management experiment when compared to Quest Diagnostics. Quest is unwilling to use marginal-cost pricing unless forced to defend existing business. Instead, Quest is attempting to realign the capacity of its network of regional laboratories to better match demand for the markets served by its system.

Readers of THE DARK REPORT will recall that Quest Diagnostics announced last December that it would close laboratories in Tampa and Atlanta, downsize the St. Louis operation, and restructure

National Labs Report Revenues And Profits

Revenues for first quarter 1998 demonstrate that all three laboratories are becoming similar in size. It is important for laboratory executives to watch each lab's profit performance, however. The three national laboratories must improve net earnings if they are to regain the ability to influence the marketplace the way they did in the early 1990s.



a number of satellite laboratories. *(See TDR, December 8, 1997.)* Quest stated that 6% of its work force, an estimated 1,000 employees, would be released as a consequence of this extensive downsizing project.

To accomplish this restructuring, Quest Diagnostics wrote down $70 million in the fourth quarter of 1997 and another $2.5 million in the first quarter of 1998. But Quest expects annual savings of $20 million per year will result from the restructuring project.

Here is a good opportunity to watch the outcomes for two competing strategies. SBCL's strategic priority appears to emphasize increasing specimen volume relative to restructuring and downsizing. Quest

Diagnostic's stated strategy is to emphasize better alignment of laboratory testing capacity in each market while improving pricing margins for existing and new business.

Number Of Laboratories

It should be pointed out, however, that SmithKline has progressively reduced the number of laboratories in its system over the previous five years. It also did not use acquisitions to fuel rapid growth, unlike **MetPath** (now Quest) and **National Health Laboratories** (now **Laboratory Corporation of America**). Thus, SBCL is neither burdened with a "crazy quilt" of laboratories operating with different systems nor excess capacity created by the multiple acquisitions of its laboratory competitors.

One conclusion to be made from these results is that the unbridled financial losses of 1996-97 are over. A level of stability is returning to these businesses, although their overall financial condition is still not strong.

Laboratory Corporation of America reported its first quarter earnings on April 30. Like Quest, there was a modest revenue decline accompanied by an improvement in operating profit. But LabCorp was the only one of the three blood brothers to report a net loss for the quarter, of $1.8 million. This is a slight decrease from the net profit of $2.5 million LabCorp reported after the first quarter of 1997.

LabCorp's revenues declined 4.6%, to $373.0 million. This gives LabCorp an annual run rate of $1.49 billion. This is just slightly greater than Quest Diagnostics (at $1.47 billion). LabCorp's earnings before interest, taxes, depreciation and amortization (EBITDA) for the quarter was $50.2 million. This compares favorably against Quest's EBITDA, which was $40.1 million on almost the same revenue base.

LabCorp attributes the revenue decline to three reasons. First, LabCorp is concentrating on dropping money-losing accounts. Second, changes to government and private reimbursement policies are causing a decline in physician ordering patterns. Third, hospital laboratory outreach programs are aggressively competing in the marketplace and winning business.

Cost-Cutting Benefits

First quarter financial performance of the three blood brothers indicates that each laboratory is reaping some benefit from cost-cutting efforts. Operating profits increased over the same production period in 1997.

Declines in revenue at Quest Diagnostics and LabCorp indicate that any sales growth is being neutralized by efforts to release unprofitable accounts, changes in physician ordering patterns, declines to reimbursement, and competitors who are stealing business.

One conclusion to be made from these results is that the unbridled financial losses of 1996-97 are over. A level of stability is returning to these businesses, although their overall financial condition is still not strong.

Regional laboratory competitors and hospital laboratory outreach programs which benefited from the service problems and internal operational focus of the three blood brothers should take note of these new developments. The days of easy pickin's may be over.

As the three national laboratories improve their management execution and financial condition from quarter to quarter, they will intensify sales efforts to gain additional market share. Competition for new business may once again intensify. TDR

(For further information, contact THE DARK REPORT at 503-699-0616.)

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Sales and marketing of laboratory services to physician offices is still feasible and cost-effective... if the effort is professionally managed and supported. Recently THE DARK REPORT was invited to speak at the national sales meeting of a public laboratory. Awards for 1997 sales production demonstrated that top people can still get great results. One sales representative generated $800,000 in new net revenues from physician offices in his territory for 1997.

ADD TO...SALES

Three sales reps each received a $75,000 bonus because they increased net revenues in their territories by $100,000 per month within a 24-month period ending December 31, 1997. These three sales reps boosted this lab's revenues by $3.6 million per year during that period. Professional sales programs can still make a difference!

American Medical Laboratories of Chantilly, Virginia continues to beef up its management team. The latest addition is H.W. (Bud) Gandee, Jr. He will become Vice President of Hospital Alliances and Business Ventures. Bud has a distinguished career in consulting and managing hospital laboratories. He was with **Allied Clinical Laboratories** from its founding. Most recently he was with **Laboratory Corporation of America**.

HEALTHSOUTH ADDS 34 SURGICENTERS

The biggest just got bigger. **Healthsouth Corp.** paid $550 million to **Columbia/HCA Healthcare Corp.** to acquire its 34 stand-alone surgicenters. When completed, Healthsouth will own 212 surgicenters, more than any other company in the United States. Anatomic pathology (AP) specimens generated by surgicenters represents a growing volume of AP work. Look for pathology PPMs to try and negotiate exclusive provider arrangements for the AP business originating within Healthsouth's surgicenters.

Here's a positive development for the clinical laboratory industry. According to Michael Arnold, Legislative Advocate for the **California Clinical Laboratory Association** (CCLA), the state Assembly Health Committee passed a bill to permit direct laboratory access by patients (AB2056). The bill would permit patients to order specified tests without a physician's referral. The bill must be voted upon by the full assembly, then goes to the state senate for approval.

Meanwhile, a state judge in New York ruled that laboratory directors of a clinical laboratory that allegedly misread two Pap smears could be liable for damages, even though they did not personally review the slides in question. The judge's ruling demonstrates how rapidly case law is altering traditional boundaries for the legal responsibility borne by laboratory managers.

What three states have the highest percentage of Medicaid managed care enrollment? If you said Tennessee (100.0%), Washington (99.8%), and Oregon (90.0%), then you understand how rapidly managed care is transforming Medicaid programs. Recent data from HCFA indicate that 40% of the nation's Medicaid beneficiaries are now enrolled in managed care plans.

That's all the insider intelligence for this report. Look for the next briefing on Monday, May 25, 1998

THE DARK REPORT

UPCOMING...

- Quarterly Earnings Of Public Specialty Labs Marked By Strong Revenue & Profit Growth.
- Battle Against Overreaching Government Fraud Investigations Gets A New Weapon.
- Pathology Practice Doubles In Size Even As It Protects & Enhances Profit Margins.
- New Tools Allow Laboratories To Integrate Existing LIS With Physicians Offices.