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From the Desk of R. Lewis Dark...

THE DARK REPORT

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

Restricted information, see page 2

Commentary & Opinion by...

R Lewis Dark

Founder & Publisher

Shift in Lab & Pathology Management Thinking

FROM ALL THAT I HEAR, this year's *Executive War College* was the best ever. With almost 50 speakers and 400+ attendees from the United States and countries as remote as Oman, it is a real accomplishment to produce what is increasingly recognized as the finest gathering of management executives in clinical laboratory and pathology.

As a somewhat reclusive curmudgeon, attending these industry soirees is not my cup of tea. I participate vicariously, however. I have extensive conversations with our Editor, listen to the audio cassette tapes, and speak freely with colleagues about what occurred at the program.

From my perspective, the most notable fact about this year's *Executive War College* is that the influence of money is beginning to change the way laboratorians view their laboratory. On one hand, the economics of running a lab with constantly-declining costs continually pressures lab administrators and pathologists to do better. On the other hand, the booming profits of the public lab and pathology companies incentivizes them to expand their competitive market share. This pushes hospital-based lab administrators and local pathology group practices to respond with new business strategies.

It's Adam Smith's invisible hand doing its magic in the laboratory marketplace. Everyone is working in his/her self interest with the collective result that hospitals, physicians, and patients get better quality lab tests at reasonable prices. The invisible hand has definitely put many lab administrators under lots of unpleasant pressure in recent years. That's why the hospital lab segment of the industry looks much different today than it did in 1995.

Speeches at this *War College* now demonstrate that the inexorable pressure of the invisible hand has finally done something we've struggled to accomplish since the founding of THE DARK REPORT. In all segments of the lab community, including hospital labs, independent labs, and pathology group practices, there is now a growing recognition that companies outside of healthcare may have management tools and methods which can find useful application in a clinical laboratory! Wow! That's exciting!

Just imagine what can happen to the lab industry as our innovators find useful management models in firms like **General Electric**, **Southwest Airlines**, and **Intel**, to name a few, and successfully incorporate them into laboratory operations. It's the type of innovation which breeds success! TDR

Lab Owners Selling Stock To Harvest Big Profits

Unilab's proposed IPO is one of three major stock sales by laboratory owners

***CEO SUMMARY:* Three huge stock sales involving the nation's largest laboratories have been announced in recent weeks. If these stock sales are enthusiastically received by Wall Street investors, independent regional lab owners may benefit because of higher valuations for clinical laboratory companies. In particular, Unilab's IPO will be seen as a benchmark of laboratory business values.**

DURING THE NEXT FEW MONTHS, owners of three large laboratory companies will sell major blocks of stock totaling more than $1 billion dollars.

Resurging investor interest in clinical laboratory company stocks encourages these owners to harvest profits. But in so doing, they will also help establish new valuations for independent clinical laboratory companies.

On May 2, **GlaxoSmithKline PLC** sold 1.5 million shares of **Quest Diagnostics Incorporated**. Glaxo realized $179.3 million from the sale.

The following day, May 3, **Unilab Corporation** filed a registration statement with the **Securities and Exchange Commission** (SEC). Unilab hopes to raise $115 million from this initial public offering (IPO) while increasing the liquidity of its stock.

Following these two announcements, on May 10, **Roche Holdings, Inc.** filed an offering to sell 5.5 million shares of **Laboratory Corporation of America**. At current prices, Roche could realize as much as $763.8 million from this offering.

There is a different motive behind each lab company's stock sale. In the case of GlaxoSmithKline and Roche, the two pharmaceutical companies both want to raise cash to fund research into new drugs.

Also, the financial performance of both companies has been lackluster in recent quarters. As a result, investors are pressuring both companies to take

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

SUBSCRIPTION TO THE DARK REPORT INTELLIGENCE SERVICE, which includes THE DARK REPORT plus timely briefings and private teleconferences, is $11.90 per week in the US, $12.50 per week in Canada, $13.55 per week elsewhere (billed semi-annually).

active steps to boost earnings. Selling passive stock investments in Quest Diagnostics and LabCorp allows these pharma giants to lock-in recent profits and invest these funds into drug discovery programs.

> ***...it is a significant fact that the stock market will absorb $1 billion of clinical lab stocks from these three sales. It is a sign that independent regional laboratories will find it easier to raise capital.***

Even after these big stock sales, GlaxoSmithKline and Roche will hold major stakes in Quest Diagnostics and Lab Corp. GlaxoSmithKline still owns 11.1 million shares of Quest Diagnostics. This is 24% of Quest's outstanding shares and is worth about $1.3 billion. Roche will continue to own 16.7% of LabCorp. Its 5.8 million remaining shares are worth about $731 million.

Unilab's impending stock sale has several interesting aspects. Since it is already the dominant commercial laboratory in California, Unilab's IPO is not expected to change the existing competitive balance among labs in that state. There are other reasons why Unilab wants to raise cash and create a public market for its stock.

Currently Unilab's major shareholder is **Kelso & Company, Inc.**, a private equity investment company based in New York City. Kelso and its affiliates bought Unilab and took it private in 1999. They own 82.7% of Unilab. At some point Kelso wants to sell its Unilab stake and harvest what it hopes will be ample profits. The objective of Unilab's IPO is to strengthen the lab's balance sheet and increase the liquidity of its stock.

For lab executives and pathologists, the Unilab story is interesting for several reasons. First, Unilab's IPO will demonstrate whether or not the investment community remains bullish on clinical laboratories. A strong IPO will reinforce higher prices for other lab stocks.

Second, investors will use this deal as a benchmark to establish values for independent regional lab companies. A strong price for Unilab's shares will mean that pathologist-owners of independent labs can realize a higher sales price for their labs.

Third, it is known that Kelso paid a very high price for Unilab when it acquired the company in 1999. At a time when labs were selling for rather modest multiples of EBITDA (earnings before depreciation, interest, taxes, and amortization), Kelso paid almost 12 times EBITDA.

Regional Lab Valuations

To support a similar high valuation of regional labs in the future, Kelso needs to earn a sizeable profit from its Unilab investment. Thus, both professional investors and independent regional laboratory owners will be watching to see how Unilab's revenue growth translates into the high levels of profits necessary for Kelso to recover its original investment and a sizeable profit to compensate for the risk of that investment.

Taken collectively, it is a significant fact that the stock market will absorb $1 billion of clinical lab stocks from these three sales. It is a sign that independent regional laboratories will find it easier to raise capital. Hospital-based laboratories with outreach programs will also benefit. Professional investors are already known to be exploring opportunities to invest in hospital lab outreach programs. TDR

Contact Robert Michel at 503-699-0616.

Unilab Files Registration For IPO of $115 Million

California's lab giant hopes to become laboratory industry's next public company

CEO SUMMARY: During the 1990s, Unilab used the twin strategies of lab acquisitions and aggressive sales and marketing to fuel rapid growth in specimen volumes and net revenues. However, California's ultra-competitive managed care market and severe financial problems during the latter half of the decade almost sunk the laboratory. Today's Unilab is a more experienced and cautious company.

CALIFORNIA'S LARGEST lab company wants to offer its stock to the public. On May 3, 2001, **Unilab Corpora-tion** filed a registration statement with the **Securities and Exchange Commission** (SEC).

Unilab hopes to raise $115 million from this initial public offering (IPO). If it succeeds, it will be the third laboratory in the past year to complete an IPO. Last November, **Specialty Laboratories, Inc.** and **Dynacare Inc.** raised $92 million and $50 million from their respective IPOs. *(See TDR, December 4, 2000.)*

SEC "Quiet Period" Rules

Because of SEC "quiet period" rules, Unilab executives are not available to comment on the company and the IPO. However, Unilab's registration statement provides current details on how the laboratory company coped with California's managed care marketplace in recent years.

Unilab's revenues in 2000 totaled $337.5 million and operating income was $41.6 million. Unilab claims to have "25% of the California independent clinical laboratory testing market." It holds 150 managed care contracts, covering about 4.8 million beneficiaries.

To demonstrate the rock-bottom pricing for capitated lab contracts in California, Unilab says that "in Southern California, capitated reimbursement rates, according to a 1999 survey, averaged approximately 65¢ to 85¢ per member per month [PMPM]. In the same survey, areas in the northeastern United States reported rates as high as $1.50 per member per month."

Unilab's dilemma is obvious. It reports that up to 40% of its testing volume is reimbursed under capitated agreements, yet these capitated contracts account for only 15% of its revenue in 2000. So the largest portion of Unilab's test volume yields minimal revenue.

Unilab must also service a sizeable debt. Against annual revenues of $337.5 million, it has debt of $310.4 million. This debt was incurred in 1999 when **Kelso & Company, Inc.**, a

New York-based investment firm, acquired Unilab and took it private. *(See TDR, June 7, 1999.)*

This sizeable debt impacts both Unilab's profit & loss statement and balance sheet. Interest payments during 2000 totaled $37.7 million, thus reducing Unilab's net income.

Negative Shareholder Equity

The large debt burden also has a substantial impact on the balance sheet. Unilab's liabilities exceed its assets by a significant amount. At the end of 2000, Unilab's shareholder equity was a negative $112.4 million.

Unilab would like to reduce this sizeable debt. That is a major reason why the company wants to raise $115 million through the proposed IPO. Most of the proceeds are earmarked to retire debt, some portions of which carry an annual interest rate as high as 12.75%.

The other reason Unilab would like to again become a public company is that its owner, Kelso & Company, is ready to begin realizing profits from its investment. Kelso owns 82.7% of Unilab's stock.

However, Kelso also paid a premium price of 12 times EBITDA to acquire Unilab in 1999. When Unilab's annual revenues were $217 million, Kelso paid approximately $420 million to purchase Unilab.

Premium Price For Unilab

The Kelso dilemma can be aptly described by the old real estate adage that "you make your profit when you buy." In other words, paying too much for a property makes it difficult to later sell that same property at a profit.

Kelso paid a hefty premium in 1999 to acquire Unilab, a company already the dominant lab in California. Knowledgeable observers always wondered where Unilab would find the increased specimens and higher prices necessary to increase the value of the company to the point where Kelso & Associates could sell its investment at a handsome profit.

In 1999, it was believed that two business strategies would feed increased revenues and net profits into Unilab. One strategy involved lab acquisitions. The second strategy involved repricing existing managed care contracts.

Between November 1998 and August 2000, Unilab acquired four lab companies. They were **Meris Laboratories, Inc.** (November 1998), **Bio-Cypher Laboratories, Inc.** (May 1999), **Southern California Clinical Laboratories, LLC** (March 2000), and **Pathology Associates Laboratories** (August 2000).

Limited Growth Potential

Combined, these four labs added about $91.6 million in net revenues to Unilab. The combined purchase price was approximately $75.3 million. However, few independent labs of size remain in California and **Laboratory Corporation of America** also wants to acquire labs in the state. Thus, it would seem that Unilab's ability to generate significant growth from acquisitions would be limited.

The other strategy has been to reprice existing managed care contracts. As most lab executives and pathologists know, one of the amazing stories of California between 1990 and 1996 was Unilab's willingness to ink capitated managed care contracts for rates as low as 25¢ PMPM.

As a growth strategy, it certainly contributed to Unilab becoming California's largest lab company. But as a profit strategy, it proved disastrous. At its lowest financial point, in 1996, Unilab's share prices fell below a dollar and bond holders sold out for discounts

Unilab Corporation At-A-Glance

Created: 1988, when MetPath spun off lab operations in the Western United States.

Annual Test Volume: 30 million

Main Labs: Tarzana, San Jose, Sacramento

Rapid Response Labs: 38

Patient Service Centers: 344

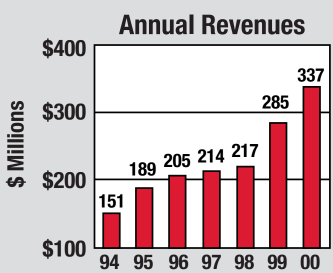
Courier Routes: 395

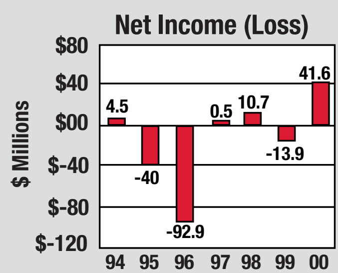
Courier Hubs: 29

Sales and Service: 75 FTEs

Executive Team:

- **Robert E. Whalen**, Chairman, President, CEO
- **Brian D. Urban**, EVP, CFO
- **David W. Gee**, EVP, General Counsel
- **Emmett Kane**, EVP, Division President, No. Calif.
- **R. Jeffrey Lanzolatta**, EVP, Division President, So. Calif
- **C. Michael Hanbury**, SR VP, Chief Scientific Officer
- **Paul T. Wertlake**, M.D., VP, Chief Medical Officer





▶ The 1990s were a financial roller coaster for Unilab. Even as revenues doubled between 1994 and 2000, net income fluctuated wildly. Future prospects are better because of an easing in California's managed care marketplace.

of as much as 50%. The company posted a loss of $93 million on revenues of $205.2 million that year.

During the past three years, Unilab has worked to reprice its capitated managed care contracts. But because many of these contracts started with a low capitated PMPM price, even a doubling of the capitation rate at each contract renewal still places Unilab a long way from profitability on specimens covered by these contracts.

Considering the facts of Unilab's situation, it certainly faces one of the more interesting business challenges of any laboratory in the United States. With Unilab's existing dominant position in California, it would seem that future growth would have to come from expansion outside the state. The impending IPO will certainly demonstrate whether investors are receptive to Unilab's current business strategies. TDR

Specimen Transport Box Ready for Labs to Use

New technology predicted to make dry ice obsolete for transporting lab specimens

CEO SUMMARY: Maintaining the integrity of lab specimens from referring client to laboratory is one of the recurring headaches of the lab business. Now there's a new product which eliminates the use of dry ice and can maintain appropriate transport temperatures for up to 96 hours. Called "Friobox," it's one more example of how technology developed outside healthcare can improve laboratory performance.

DRY ICE MAY BECOME a thing of the past in laboratory courier departments around the United States if distributors of a new product called "Friobox" have their way.

Friobox utilizes technology which keeps lab specimens either frozen or cool for 96 hours, without using dry ice. Originally introduced in Europe, it has only recently become available for laboratories in the United States.

THE DARK REPORT was given a demonstration of this product during the *Executive War College* in Cincinnati on May 8-9. It is a robust technology that has been in use in Europe for several years.

Comes In Two Sizes

Friobox comes in two types. The "positive model" will maintain specimens at 35°F–42°F for four days. Retail prices for the two-liter and five-liter sizes are $27 and $29, respectively. The "negative model" maintains specimens at -13°F to -3°F for four days. Retail prices for the two-liter and five-liter sizes are $41 and $43, respectively.

The container is designed for reuse. Its effective life is rated at 12 round trips. Friobox eliminates the need for dry ice and improves specimen integrity during transport by airlines and other public carriers. For these reasons, it is attracting serious interest by lab executives who have had the opportunity to evaluate the product.

Developed In Europe

"Friobox was developed in Europe and is used to transport vaccines, organs, tissues, and lab specimens," stated Bernie Ness, President of **B.J. Ness Consulting Group, Ltd.** and the U.S. distributor of Friobox along with Randy Miller and Jim LeClair. "The technology is certified and Friobox won the top European packaging design award last year," he added.

Clients and readers of THE DARK REPORT are among the first to learn about Friobox. "Last month we began shipping Friobox to such laboratory companies as **Thrombocare** in Dallas (a coag and specialty hematology lab), **Ampersand Medical** in Chicago (cervical cancer screening products), **Carolina Donor Services** in Durham (organ transplants) and **TriCore Reference Laboratories** in Albuquerque," stated Ness.

"We see two fundamental advantages to Friobox," he continued. "First, it absolutely maintains the temperature of the specimen for a full four days. This is added protection for tissue biopsies and other specimens that are 'irreplaceable.'

Spoiled Lab Specimens

"Most labs receive a regular percentage of shipments where the specimen was spoiled in transit—and had to call the referring physician with the bad news," added Ness. "Consider Friobox to be the next level of protection for frozen and cooled lab specimens.

"Second, the overall cost per use of Friobox is competitive with existing packaging that relies on dry ice," Ness observed. "The new technology allows a lab to eliminate the cost of dry ice, the added freight costs from heavier packages, and the labor involved in inventorying, handling, and packing dry ice into specimen boxes.

"The other feature which is important for laboratories is the D-5 shipping container, with about four to five pounds of dry ice, can only protect a lab specimen for two days (48 hours)," he explained. "Friobox is rated at four days (96 hours).

Delayed In Transit

"This is important protection for lab specimens, particularly during three-day holiday weekends or when weather problems delay specimens in transit," he concluded.

THE DARK REPORT considers Friobox to be "paradigm-shifting" technology. However, as these pages have chronicled so often in the past, lab executives and pathologists are slow to accept and use new technology that lacks a track record within the lab industry.

For example, the courier department at one of the nation's leading hospital reference labs was given a Friobox sample twelve months ago—but management never experimented with the product to verify its performance, despite its potential to virtually eliminate specimens spoiled in transit, at a cost equal or less than existing dry ice packaging.

It appears likely that lab administrators at smaller labs will adopt this product ahead of the bigger labs. With direct accountability in their organizations, they will be willing to test the product in the field and not worry about "making a wrong decision."

However, assuming the lab industry's early adopters demonstrate that Friobox is: 1) better technology for shipping lab specimens, and; 2) offers economic advantages that at least equal existing dry ice methodologies; then Friobox has the potential to eventurally become the "standard of care" for transportation of lab specimens.

Actively Seeking Deals

Generally, THE DARK REPORT does not cover the introduction of specific commercial products. However, after seeing the demonstration of Friobox at the *Executive War College* and learning about some of the "luddite" reactions of prospective lab customers, we thought it would be useful to brief our clients on this product and let them watch the product introduction curve unfold for themselves.

We've done this before, with briefings about efforts to introduce enhanced Pap smear screening products (anyone remember PapNet?) and the new crop of multiplex testing (**Luminex**) and POC testing (**Careside**, **Qualigen**). After all, it's *always* the marketplace which makes the ultimate determination! **TDR**

Contact Bernie Ness at 800-280-3785 or visit www.howmil.com to see product specifications.

Laboratories Facing New Management Challenges

Changing Lab Industry Trends Identified at War College

***CEO SUMMARY:* Clinical laboratories and pathology group practices are beginning to respond to a new set of marketplace trends. Speaker after speaker at this EXECUTIVE WAR COLLEGE included new business strategies not heard in past years. Probably the most notable difference is a growing emphasis on developing and delivering value-added services which go beyond simply reporting the lab test results to the referring physician. Labs are also formulating business strategies to meet changing consumer needs. Not surprisingly, Internet-based lab services continue to be a subject of high interest among laboratory professionals.**

MOST LABORATORIANS AGREE THAT the decade of the 1990s was marked by nonstop financial turmoil and wrenching operational change for clinical labs and pathology group practices.

In contrast, the early part of this decade is relatively calm, giving labs and pathology groups the opportunity to assess current healthcare market trends and develop appropriate business strategies to profit from these trends.

Latest In Lab Industry Trends

Earlier this month, more than 400 senior lab executives and pathologists gathered in Cincinnati for the Sixth Annual *Executive War College on Lab and Pathology Management*. A distinguished faculty of almost 50 presenters was there to share the latest in market trends, business strategies, and operational innovations that affect laboratories.

In contrast to earlier *War Colleges*, I noticed that this year's gathering was highly optimistic and relaxed. Most lab administrators and pathologists commented that their laboratories were financially stable and not under the extreme cost-cutting duress that was so prevalent from the mid-1990s forward.

Such optimism is a notable fact. A significant number of attendees are hospital-based laboratorians. Their statements about the financial stability of their laboratories is congruent with the strong profits posted by public lab and pathology companies. Taken together, these are confirming signs that the lab industry is enjoying widespread financial stability.

Wealth of Management Ideas

Two things make the *Executive War College* a unique place to gauge the "state of the lab industry." First, almost 50 innovative laboratorians provide presentations on a wealth of lab and pathology management topics. These are cutting-edge lab organizations and their business initiatives represent "best of class" in lab management thinking.

Second, the 400+ attendees represent an extraordinary cross section of senior laboratory executives and pathologists. The *War College* audience also includes a growing contingent of international lab executives. This year's participants included laboratorians from Australia, New Zealand, Brazil, and even the Persian Gulf country of Oman.

These individuals are movers and shakers in their own right. Their observations and criticisms about the presentations are rich with insight and knowledge.

Add these two influences together, and it creates an exceptional opportunity to judge what's happening in the laboratory and pathology professions today—and what's about to happen in the next 24 to 36 months.

This year I could identify five broad themes on lab management from the speakers and the attendees. These themes represent basic influences and trends shaping healthcare and laboratory testing services. Here is a brief synopsis of each:

THEME 1 ▶ EMPHASIS ON OPERATIONAL EXCELLENCE

Now that most of the nation's leading laboratory innovators have consolidated lab functions and joined regional lab networks, the "era of widespread lab consolidation" seems to be at an end.

The management focus at these labs is shifting toward two basic goals. First, to improve productivity and lower costs within the laboratory. Second, to improve the quality of service to physicians and patients by reducing lab errors in such areas as couriers, specimen handling, bench testing, and billing/collections.

This shift in management thinking can be categorized "operational execution." Now the emphasis is on work processes within the lab and how to improve the productivity of every aspect of laboratory operations.

At this year's *War College*, some of the most popular sessions involved case studies of laboratories which were improving their execution of work processes. For example, Ken Geromini, CEO of **Life Laboratories**, a modest-sized lab in Springfield, Massachusetts, explained how the use of new productivity measuring tools offered through **Premier, Inc.** generated $440,000 in value improvement.

Similarly, **BayCare Health System Laboratories** in Tampa, Florida reported similar successes with Six Sigma and lean thinking tools. Victor Hruszyzck, VP of Lab Services, chronicled how, with the help of the consulting division of **Ortho Clinical Diagnostics**, BayCare Labs rationalized work flows, identified systemic glitches in work practices, and generated a variety of improvements. For example, productivity per technical FTE jumped from 86,700 tests per year to over 125,000 tests per year, a gain of 44%!

THEME 2 ▶

CHANGING INFLUENCE OF MANAGED CARE

Managed care is lessening as a source of financial pressure and inadequate reimbursement upon labs and pathology groups. During podium presentations, there were few references to financial issues and patient access problems attributable to managed care contracting practices.

This is a definite change from previous years, when lab administrators emphasized the strategic need for their labs to participate in the major managed care contracts in their region.

This year, many labs are viewing managed care as an opportunity. They want to develop value-added lab services which managed care companies find useful.

Typical of this new business attitude is **Bio-Reference Laboratories, Inc.** of Elmwood Park, New Jersey. During his presentation, CEO Marc Grodman, M.D. detailed several business initiatives the lab is funding to take raw lab test data and convert it into useful knowledge that adds value to both clinicians and payers.

This theme was solidly endorsed by Richard Migliori, M.D., Chief Clinical Strategist at **Ingenix**, a division of **United Healthcare Corporation** of Minneapolis, Minnesota. Dr. Migliori demonstrated to the *War College* audience how new software programs were combining medical claims, prescriptions, lab data, and other clinical information to identify opportunities to improve care.

In particular, Dr. Migliori explained the way Ingenix was making this new knowledge available to clinicians. Using such knowledge, which had earlier been unavailable, physicians were now able to make more informed decisions about patient care.

This information was helping them to eliminate oversights and treatment errors that might have otherwise gone undetected. More importantly, these new data sets were giving physicians very precise tools to use in improving healthcare outcomes.

THEME 3 ▶

IMPACT OF INTERNET AND NEW INFORMATION TECHNOLOGIES

Based on presentations and comments during the *War College*, it is clear that the nation's early-adopter labs are closely tracking efforts to shift healthcare operations and clinical services onto Web-based platforms.

These laboratories are formulating strategic plans to respond to the Internet and use new technologies for collecting, storing, and evaluating laboratory test data.

Osama Sherif, the COO of **Dynacare, Inc.,** presented the details of Web-accessed lab test results reporting for client physicians. Equally fascinating was the presentation by **Caresoft, Inc.** Executive Vice President Nathan Schultz. His company's Web site, *www.mydailyapple.com*, is the portal that patients of **Quest Diagnostics Incorporated** use to access and view their lab test results.

Many of the labs making presentations outlined their phase-one Internet business strategy. They are actively investing management resources and capital to implement their first generation of Web-based lab testing services.

THEME 4 ►

NEW APPRECIATION OF CORPORATE MANAGEMENT METHODS

For the first time in the six-year history of the *Executive War College*, almost every lab administrator and pathologist speaking at the podium described his or her lab's business strategies in terms of management philosophies studied and copied from companies outside healthcare.

This is an important change and marks the beginning of a healthy trend. For years, laboratorians have paid little attention to management methods and innovations used outside healthcare. But this year, speaker after speaker described how their lab or pathology group was drawing management wisdom and methods from the likes of **General Electric**, **Home Depot**, **Emerson Electric**, **Intel**, and other corporations with a reputation for management excellence.

In fact, several speakers referred to the management concept of "disruptive technology," presented at last year's *War College*. Although non-specific to laboratory management, the concept of disruptive technology and its ability to displace market leaders without warning clearly influenced the strategic management thinking of several *War College* attendees from 2000.

The frequency with which lab administrators and pathologists mentioned management precepts used by non-healthcare corporations caught me by surprise this year. It's a sign that the lab and pathology profession may finally be abandoning its traditional and rather insular attitude of "if it's not been tried in a laboratory, it's probably not something I'll find useful."

If true, this is a breakthrough trend. The willingness of lab administrators to go outside healthcare for management inspiration can stimulate a renaissance in the management of laboratories and pathology groups.

THEME 5 ►

RECOGNITION OF IMPENDING CHANGES TO WAY LABS ARE ORGANIZED & OPERATED

This is the "trend before the trend." There is growing recognition that new technologies under development will fundamentally change the way laboratories are organized and operated.

Speakers at this year's *Executive War College* noted that several factors were already stimulating them to think differently about the way their laboratory is organized. Influences ranged from the shortage of medical technologists and new automation solutions in lab equipment to Internet-based lab information services and the impending dispersal of routine testing as a result of innovations to point-of-care testing (POCT) devices.

Many speakers made the same strategic observation. They can foresee that Internet-based communications will combine with new technologies for diagnostic testing. These new tools will give lab administrators the freedom to create laboratory structures capable of accurately performing tests in settings different from the current core laboratory structure.

Of course that day has yet to arrive. But what is notable is that early-adopter laboratories have already plugged this assumption into their strategic business plan. They are building a structural flexibility into their planning process.

As a result, these labs are preparing themselves for the day when it will be better and more economical to use an unorthodox organizational structure to operate their laboratory. This might mean that the LIS function and laboratory data storage is done by a remote host ASP (application service provider). It might utilize new technologies to do many routine tests closer to the point-of-care, even as the laboratory maintains its traditional responsibility for test accuracy, reproducibility, and interpretation of results.

In essence, this year's faculty presentors were serving notice that they are ready to change the operational form of their lab away from the traditional core lab organization—but only as new technology enables them to do this and still provide high quality testing to the referring physicians.

Common Themes

These five trends presented represent the common themes contained within the 50 presentations at this year's *Executive War College*. Validation came from the comments of the 400+ attendees in conversations during the course of the event.

Hospital Labs Emphasizing Enhanced Test Services

ONE INTERESTING OBSERVATION which emerged from this *War College* is the fact that a growing number of hospital laboratories are turning their attention to how they can add more value to their referring physicians.

Typical of this phenomenon is **HealthMidwest**, a nine-hospital health system with a consolidated core lab based in Kansas City. Director of Laboratories and Pathology, L. Patrick James, M.D., told a fascinated *War College* audience how, post-consolidation, the laboratory turned inward to identify opportunities to improve the care at the health system.

One project was to integrate lab activities with pharmacy activities. The goal was to improve how microbiology test data was used to support the ordering of appropriate antibiotics. Annual savings approaching $1 million resulted from this combined lab-pharmacy initiative.

Clearly the course of laboratory management is assuming new directions. In particular, I think the emphasis on "operational excellence" and the desire to learn new management methods to achieve this is an important development.

Greater Lab Productivity

Acquiring more sophisticated management expertise gives lab administrators and pathologists the tools they need to achieve cost reductions without resorting to employee layoffs. It also means they can achieve much greater productivity improvements than was typically seen in the last decade.

This heightened interest in the art and science of management is timely. It gives lab administrators the tools they need to get the most "bang for the buck" from the Internet and various new diagnostic technologies soon to arrive. TDR

Contact Robert Michel at 503-699-0616.

Laboratory Web Watch

Abaton.com Will Not Be Offered As Stand-Alone Lab Solution

EARLY-ADOPTER LABS now using **Abaton.com** for Web-based lab test ordering and results reporting will have to switch to a new software product.

McKesson HBOC notified existing laboratory users of the Abaton.com product that it will no longer be supported as a stand-alone solution for Web-accessed lab test ordering and results reporting. Lab customers have been given twelve months to find another software solution.

Abaton.com will continue to be sold by McKesson HBOC, but only to integrated delivery networks (IDNs) as part of an integrated suite of clinical information products and services.

Among the laboratories affected by this corporate decision are **Allina Health System** in Minneapolis, Minnesota; **Centrex Clinical Laboratories** in New Hartford, New York; and **Weill Cornell Medical Center of New York-Presbyterian Hospital** in New York City.

Ready To Capture Market

Only 18 months ago, Abaton.com was positioned to capture a significant share of the market for Web-accessed laboratory test ordering and results reporting. It had a robust ASP (application service provider) software solution that was reasonably priced.

More importantly, unlike many of its competitors, Abaton.com was able to sign contracts with lab customers and then move rapidly to implement the product. Its functionality, combined with the fact that it could be up and running within just a few months, made it a leader in this emerging market segment.

However, Abaton.com had been acquired by McKesson HBOC in the fall of 1999. In the rush to convert itself into an "e-health" company, McKesson HBOC underwent several reorganizations which affected its new Abaton.com division.

iMcKesson Disbanded

These corporate reorganizations included the ill-fated iMcKesson effort, which was disbanded earlier this year after less than eight months of operation. Abaton.com had been put into iMcKesson.

McKesson HBOC's current business strategy is to offer its IDN customers an integrated product suite of software products and services. Abaton.com will be part of this product offering. It will only be sold to IDNs and will not be available for purchase as a separate, stand-alone solution for use by clinical laboratories.

The Abaton.com story is another example of a robust product which has yet to get the right focus and support by its corporate parent. As an independent company, Abaton.com had a clear vision and was moving steadily into both the IDN and laboratory markets. Within McKesson HBOC, it has become an undervalued asset.

This story is a reminder that labs and pathology groups should exercise caution when selecting a software vendor. It's still a rough and tumble market for Web-based software products. TDR

Dark Index

Public Labs Enjoy Boom Times As Revenues & Profits Climb

First quarter earnings reports demonstrate that lab industry is returning to financial health

TAKEN COLLECTIVELY, second quarter earnings reports by public lab and pathology companies send a strong message: the lab industry is in the midst of a revenue and profit boom.

It's been more than a decade since every public lab and pathology company reported strong growth in both revenues and operating profits. This is an important fact. These healthy increases in operating profits give commercial lab companies more financial resources to compete for additional business.

Intensified Competition

Hospital laboratory outreach programs and local pathology group practices should be ready to see intensified competition for lab testing and biopsy business. For the first time in several years, national lab companies can devote additional resources and management attention to improving the effectiveness of their sales and marketing programs. Their goal will be to increase market share at the expense of local lab testing providers.

A survey of the public lab and pathology companies demonstrates the extent to which the current healthcare marketplace is supporting growth in lab testing revenues and operating profits. Here's a brief profile on each.

Quest Diagnostics Incorporated: First quarter revenues were $883 million, a gain of 7% over same quarter last year with adjustments for its network management business. But net income doubled, from $17.8 million in Q1-00 to $35.7 million in Q1-01.

Two statistics would indicate that Quest Diagnostics' operational emphasis on ISO-9000 and Six Sigma is taking hold. Days sales outstanding (DSO) improved to 51 days, compared to 56 days at the end of fourth quarter. This is probably the lowest DSO in the lab industry. At the same time, bad debt expense, the measure of how successfully a lab is collecting the money owed it, dropped to 6.3% from 7.3% for same quarter last year.

Laboratory Corporation of America: Financial gains were equally strong at LabCorp. Revenues jumped 13.6%, reaching $525.4 million, compared to $462.7 million for Q1 last year. Net earnings climbed 69.3% reaching $43.5 million in Q1-01 from $25.7 million in Q1-00.

Days sales outstanding (DSO) at LabCorp is currently 67. LabCorp attributes its revenue increase of 13.6% to a 6.2% increase in volume and a 7.4% increase in price.

Dynacare, Inc.: Now the third largest public lab when measured by revenue, Dynacare's revenue growth has been fueled primarily by lab acquisitions and hospital laboratory partnerships.

Revenues for first quarter were $95.8 million, a gain of 19.9% from the $79.9 million during the same quarter last year. Dynacare reported modest net earnings of $2.1 million for first quarter. Like the two blood brothers, days sales outstanding improved at Dynacare. It was 63 days, an improvement from a DSO of 69 days at March 31, 2000.

LabOne, Inc.: It was a similar story at Lab*One*. Revenues jumped 23% for the quarter, reaching $50.0 million compared to $40.5 million for same quarter last year. Net income remained unchanged at $.04 million.

Specialty Laboratories, Inc.: Because of its exclusive focus on esoteric and reference testing, Specialty Labs is quite different than the other public labs reported here. Nonetheless, Specialty Labs is also enjoying rapid growth. Revenues hit $43.8 million, a gain of 23%. Net income jumped 86%, from $1.9 million in Q1-00 to $3.4 million in Q1-01.

Bio-Reference Laboratories: For the quarter ending January 31, 2001, revenues increased 22%, to $18.4 million. Operating income jumped 139%, to $.5 million from a loss of $.1 million for same period last year.

Public Pathology Companies

Across the board, public pathology firms have posted equally strong gains in revenue and operating profits. Here's a look at the major national pathology companies.

AmeriPath, Inc.: This is the first full quarter that AmeriPath can include the revenues from its fall 2000 acquisition of **InformDX**. Quarterly revenues grew to $98.7 million, a gain of 32% over first quarter 2000. Net income increased by 26.1%, from $6.1 million to $7.7 million.

DIANON SYSTEMS, Inc.: First quarter revenues were $26.8 million, a gain of 21% over same quarter last year, which totaled $22.1 million. Net income climbed 63%, from $1.3 million in Q1-00 to $2.1 million in Q1-01. DIANON reports a DSO of 77 days.

IMPATH, Inc.: IMPATH enjoyed a 38% increase in revenues, posting $42.1 million compared to $30.5 million in same quarter 2000. Net income climbed from $2.8 million to $4.0 million, an increase of 42%.

Days sales outstanding at IMPATH have been a problem. The company currently reports a DSO of 123 days. Effectively, this means that four months of annual revenue is tied up in collections. The company did not disclose bad debt, a number which would be affected by old and uncollectable claims.

What Does This All Mean?

It is a significant fact that every public laboratory and pathology company is reporting double digit growth for first quarter 2001. It means the demand for diagnostic testing within the healthcare system is growing. This has been expected, particularly as demographics move baby-boomers into the senior citizen category and they require more health care services.

But it is also a sign that the growing number of diagnostic tests is finding useful applications. From liquid preparation Pap smears to HIV typing and viral load testing, clinicians are ordering more tests. More importantly, they are ordering these tests because it helps them improve the quality of healthcare and also reduce the overall cost per episode of care.

THE DARK REPORT continues to believe that the financial successes generated by the public lab and pathology companies will have far-reaching impact upon the clinical laboratory industry as a whole. There are at least four reasons why this should be true.

First, investors see the profits earned by commercial labs and national pathology companies. This encourages them to look for undeveloped opportunities. For example, almost every independent lab owner in the United States can tell stories about the regular calls they get from investment groups seeking to buy their labs. These investors are searching for a platform laboratory company into which they can pump capital and management savvy to make it grow.

If current rates of growth continue, within a couple of years, physicians will be referring almost $1 billion worth of specimens to just four or five anatomic pathology companies.

Second, when public lab companies have profits, they invest these profits into sales and marketing programs so they can continue to grow. This places pressure upon hospital lab outreach programs which prefer to maintain the status quo in their market. Thus, the competitive pressure increases on local lab providers.

Enhanced Lab Services

Third, the opposite is also true. Increased competition by national labs on local hospital campuses frequently raises the competitive stakes. It stimulates the hospital lab outreach program to innovate and offer an enhanced menu of lab services to maintain and expand its own competitive market share. Certainly over the last decade some of the best innovations in laboratory testing services have originated with hospital lab outreach programs.

Fourth, whether most pathologists like it or not, the stunning and sustained success of the national pathology companies is changing the basic market for anatomic pathology (AP) services.

The reason is simple. These national pathology companies are willing to invest in improved AP services. They are also willing to invest in a professional sales and marketing program which educates referring physicians about the benefits of doing business with a national pathology company.

Look at what's happened to the anatomic pathology marketplace during the past five years. AmeriPath has grown to a $400 million per year company. DIANON Systems will do $100 million this year. IMPATH is on track to over $150 million in 2001. These numbers do not include the revenue gains posted by Quest Diagnostics and LabCorp with their brand of AP services.

Far-Reaching Impact

All of this is happening for a reason. The national pathology companies are growing only because an increasing number of physicians, once they try a national pathology company, are satisfied enough to continue referring specimens.

If current rates of growth continue, within a couple of years, physicians will be referring almost $1 billion worth of specimens to just four or five anatomic pathology companies. THE DARK REPORT believes this is triggering a fundamental shift in how physicians utilize anatomic pathology services.

In simplest terms, the expectations of the anatomic pathology physician-customer are changing. Once these expectations have changed, there is no going back to the old system of providing AP services.

Given the current evolution of the AP marketplace, local anatomic pathology practices would be well served to re-evaluate their existing business strategies and identify ways to retain and improve their existing share of their local healthcare marketplace. TDR

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

As predicted in the last issue of THE DARK REPORT, **Quest Diagnostics Incorporated** did acquire all the remaining shares of **MedPlus, Inc.** which it didn't already own. MedPlus offers a variety of clinical information products, including one to create and manage electronic patient records.

KEN FREEMAN JOINS BOARD AT TRW

Kenneth W. Freeman, Chairman and CEO of **Quest Diagnostics Incorporated**, was recently elected to **TRW, Inc.'s** board of directors. Most people know that TRW was once one of the three major consumer credit repositories. It is now developing information products for healthcare. Adding Freeman to its board may indicate that TRW would like to develop services involving the electronic medical record (EMR), which would include clinical lab data. This would dovetail with Quest's recent acquisition of MedPlus and its products for managing clinical data, including patient EMRs.

NEW CHOLESTEROL GUIDELINES COULD PUT 36 MILLION ON DRUG THERAPY

Publication of the first new cholesterol standards in eight years last week garnered national headlines and may substantially boost the volume of diagnostic tests involved in cholesterol monitoring. The **National Cholesterol Education Program's** expert committee, under the aegis of the **National Institutes of Health** (NIH) published guidelines that call for "anyone who already has coronary artery disease and whose LDL, or 'bad' cholesterol, is above 130 generally should be on drug therapy." Experts predict this would triple, to 36 million people (18% of the American population), the number of individuals on cholesterol-lowering drugs.

MORE ON: CHOLESTEROL

Most press headlines emphasized how the new guidelines would triple the number of people on cholesterol drug therapy and increase the prescription costs associated with this therapy to as much as $30 billion per year. However, less attention was paid to the fact that all these "new" patients would require diagnostic and monitoring tests. These new guidelines also demonstrate another dimension to the changing healthcare marketplace. As new disease management guidelines are developed, diagnostic, prognostic, and monitoring tests will play an increasingly important role.

STRATEGIC CHANGES AT USLABS IN IRVINE

Originally organized to serve pathologists during the heyday of the PPM (physician practice management) company, **USLabs, Inc.** in Irvine, California has quietly been transforming itself. During the past 18 months, USLabs CEO Michael Danzi has shifted the company's strategic pathology services to compete in the same cancer diagnostics market as **IMPATH, Inc.** Instrumental in this process has been a team of marketing and sales executives formerly with **Ventana Systems. Inc.**

That's all the insider intelligence for this report. Look for the next briefing on Monday, June 11, 2001.

UPCOMING...

- THE DARK REPORT's *Annual Ranking of the Top Ten LIS Vendors.*
- *How United Healthcare's Ingenix Division Wants to Use Lab Data to Improve Clinical Outcomes.*
- *Community Hospital Pathology Group Crafts a Formula to Increase Revenues.*
- *Roundtable Talk: Early-Adopter Lab Administrators Share Methods for Driving Down Costs, Boosting Productivity.*