Volume V, Number 13 Monday, September 28, 1998

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

Consolidation: Threat Or Opportunity

IS CONSOLIDATION GOOD OR BAD FOR OUR HEALTHCARE SYSTEM? I don't know if any of us could accurately answer that question. For better or for worse, big corporations will continue to buy up the little guys.

I do feel confident in predicting that onging consolidation will occur in all areas of healthcare. Among our readership, hospital laboratory consolidation continues apace. Pathology practice consolidation is certainly under way and will affect increasing numbers of pathologists.

Given that the process of consolidation will be with us for many years into the future, what should be the response of laboratory executives and pathologists? Is consolidation a threat? Or is consolidation an opportunity?

Consolidation would indeed be a threat for anyone who believes that their job would be affected by an unwelcome aquisition. But I offer another perspective. This perspective is directed towards the leaders of clinical labs and pathology practices.

As leaders, it is your responsibility to accurately assess market trends and guide your business appropriately. Employees and partners depend on your insight and guidance to maintain a financially stable company. It is in that spirit that I offer you this insight: consolidation which affects your market area is an opportunity for you and your laboratory to gain market share.

Most big companies find it difficult to offer superior customer service. They also struggle to respond appropriately to the unique quirks of local markets. In that respect, consolidation works against their success because it makes it more difficult for them to be responsive in the market. Their strength usually derives from the cost advantage they enjoy due to economies of scale and their ample war chest of capital to throw at sales and marketing.

Within the commercial laboratory industry, the three blood brothers demonstrate the truth of this. If their large size translated into superior customer service, why haven't they become crushingly dominant in every city where they provide testing?

Therein lies the opportunity for independent commercial laboratories and pathology practices. Their ability to respond quickly to market changes, their local presence, and their long-standing client relationships give them a leg up when competing for business. Anytime the big boys get bigger, these nimble local competitors can frequently take advantage of post-consolidation confusion to gain market share. That is why I see consolidation as an opportunity for many independent labs and pathology practices. TDR

Bayer Acquires Chiron In Consolidation Move

Bayer expects increased market clout with Chiron's diagnostic product lines

CEO SUMMARY: As expected, consolidation within the diagnostics industry continues. This time it is Bayer, spending $1.1 billion to acquire Chiron's diagnostics business. Once completed, Bayer will be the fourth-largest diagnostics company in the world. Laboratory customers of both firms will see many changes during the 18 months following the merger.

ONCE AGAIN THE DIAGNOSTICS industry is about to undergo a major consolidation. This time **Bayer Group** has announced that it will acquire **Chiron Diagnostics**.

Bayer will pay Chiron $1.1 billion to purchase outright the diagnostics division of **Chiron Corporation**. The deal was made public on September 17.

"Bayer will gain about $600 million in revenues from the Chiron acquisition," stated Ashok Shah, Vice President of the Diagnostics Group at **IMV, Ltd.** "Added to its current revenue base of $1.1 billion, it will make Bayer the fourth largest diagnostics company in the world."

For clinical laboratory executives, this news reinforces the fact that consolidation of healthcare continues. The same pressures causing laboratory consolidation are also forcing diagnostics companies to consolidate.

"There are a number of interesting things about the Bayer-Chiron deal," said Shah. "First, this is a statement by Bayer that they are fully committed to be a major player in diagnostics.

"Second, Chiron's products fill an existing gap in Bayer's product line," he continued. "Now Bayer is better able to offer bundled instrument packages to customers such as integrated healthcare systems and the national buying consortiums like **Premiere** and **AmeriNet**.

"Third, the size of this acquisition keeps Bayer in the top rank of diagnostics' largest companies," said Shah, "This is important, because it provides Bayer the clout and economies of scale to continue as a tough player in an extremely competitive market."

THE DARK REPORT Intelligence Briefings for Laboratory CEOs, COOs, CFOs, and Pathologists are sent 17 times per year by The Dark Group, Inc., 1731 Woodland Terrace Center, Lake Oswego, Oregon 97034, Voice 1.800.560.6363, Fax 503.699.0969. **(ISSN 1097-2919.)**

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).

"What Bayer is buying is the largest company in the blood gas analyzer market," noted Andrew Schmidt, Principal at the **Kellan Group** in Alpharetta, Georgia. "Chiron currently holds at least a third of the blood gas analyzer business. **Radiometer** and **Instrumentation Laboratories** rank second and third, with market shares of approximately 25% and 22%, respectively."

"For Bayer, this is definitely a bundling strategy," Shah said. "It now has instruments for chemistry, immunochemistry, urine chemistry, and blood gas. Further, it is an important statement by Bayer that it intends to remain a strong player in diagnostics.

> ***"Chiron's diagnostics group was number one in the blood gas market, but it is a market segment generally comprised of smaller companies."***
>
> ***Ashok Shah***
> *Vice President, Diagnostics, IMV, Ltd.*

"In recent years, it seemed that Bayer lacked direction in its diagnostics division," he continued. "Many of us were wondering whether there was commitment at the highest levels of Bayer to remain in the diagnostics business.

"Acquiring Chiron's diagnostics group certainly dispels that notion," stated Shah. "Particularly since Bayer made a strong showing with its exhibits at the AACC and CLMA conventions this summer. At both shows Bayer's exhibit was definitely among the two or three most impressive booths. Many observers consider it a sign that Bayer corporate believes diagnostics is an important growth vehicle for the company."

Chiron Corporation announced its intent to sell the diagnostic group late in 1997. Chiron is primarily a biotech company. It had originally purchased this group (formerly **Ciba Corning**) from **Ciba Geigy** (now **Novartis**) in 1995. Bayer is not only getting the blood gas instrument line, but is licensing nucleic acid diagnostic technology from Chiron that involves hepatitis C (HIC) and the HIV virus.

"Bayer was one of the three logical buyers for Chiron Diagnostics," observed Schmidt. "The other two would have been **Abbott** and **Beckman Coulter**. Each of these companies could have used Chiron's blood gas analyzers to fill out their own product line and create new cross-selling opportunities."

"I consider Abbott to be the most dominant player in the immunochemistry market," stated Shah. "I think Chiron realized that, to compete in immunochemistry against Abbott and similar huge corporations, it needed a well-funded war chest and that was money they didn't have.

"Another factor in Chiron's decision to exit the business might be that the blood gas market is not as profitable as other segments," he continued. "Blood gas instruments don't use large quantities of reagents, and reagents are generally the largest source of operating margins for diagnostics companies."

More Consolidation Ahead?

Will there be more consolidation among the diagnostics companies? "I believe the answer is yes," replied Schmidt. "The Bayer-Chiron deal is in response to Beckman's purchase of Coulter and **Roche's** acquisition of **Corange** (**Boehringer Mannheim**).

"Smaller diagnostics companies need both size and huge amounts of capital to maintain market share and keep new products in the development pipeline," concluded Schmidt. "There are some surprising marriages yet to occur among the remaining diagnostics companies." TDR

(For further information, contact Ashok Shah at 301-345-2866 and Andrew Schmidt at 770-992-8713.)

Chiron Is Biotech Firm, Respected For Innovation

Chiron's foray into diagnostics was attempt to learn more about marketing its technology

CEO SUMMARY: Chiron is respected for its leadership in branched DNA and viral load technologies. The company had high expectations for its diagnostics group, particularly after its purchase of Ciba Corning. But rapid consolidation of the diagnostics industry changed Chiron's opportunity to reach the first tier of diagnostic companies. Its experience demonstrates the far-reaching impact of changes to the healthcare system.

IT ONLY TOOK THREE YEARS for **Chiron Corporation** to enter the diagnostics business and decide to get out. Chiron's experience demonstrates the rough and tumble side of the diagnostics marketplace.

Laboratory executives and pathologists are familiar with Chiron's pioneering work in immunoassay and nucleic acid diagnosis (NAD). The company is probably best known for its advances in testing for hepatitis C (HCV) and HIV.

Therametrics Strategy

Chiron's primary business strategy is based upon therametrics. Chiron defines therametrics as the process of taking related technologies for disease prevention, diagnostics, and therapeutics and marrying them into one comprehensive package.

"Therametrics is a comprehensive package that allows both the clinician and patient to work from a unified disease management protocol," explained Judy Rossi, Director of Communications for **Chiron Diagnostics**. "The therapeutics strategy is why Chiron began to develop a diagnostics group in late 1994.

"Chiron's research in the areas of immunoassay and NAD was focused toward identifying disease," continued Rossi, "but Chiron quickly realized that this technology could also have immense value in monitoring disease states."

Rossi is referring to the use of PCR and Chiron's NAD technology in viral load testing, which has rapidly expanded in recent years. Most laboratory administrators and pathologists have become aware that viral load testing, particularly among AIDS patients, is fast-growing, profitable, and has high value-added for both clinicians and patients.

"Consistent with Chiron's therametrics strategy of marrying prevention, diagnostics, and therapeutics, it was decided in 1994 that the time was right for Chiron to develop a marketing channel for the diagnostics piece of this product line," said Rossi.

"Two things were needed to accomplish this," she added. "One was practical experience–managers who understood the diagnostics business and how to bring Chiron's technology to market."

"Second was the need for a worldwide commercial infrastructure and a systems platform for its technology," continued Rossi. "The acquisition of **Ciba Corning** from **Ciba Geigy** (now **Novartis**) in 1995 provided us with both resources."

Things did not turn out as Chiron expected. "As the diagnostics group was assembled, certain therapeutic technologies were in clinical trials," explained Rossi. "Despite high expectations, clinical trials did not validate these technologies."

Need To Improve Earnings

"This caused confusion among Chiron's investors about the company's strategies. Earnings did not meet expectations and that created pressure on the executive team," she said. "This company's core competency is in biopharmaceuticals and it was recognized that diagnostics was pulling capital and management resources away from Chiron's core strength.

"It was also recognized that consolidation within the diagnostics industry was making it tougher for Chiron to build a first-tier diagnostics company," Rossi stated. "For these reasons, it was decided to pursue a strategic partnership. Chiron explored this possibility with a number of big diagnostic companies during the past year.

"In fact, that is how Chiron Diagnostics became involved with **Bayer**," continued Rossi. "During these ongoing discussions, Chiron realized that it would end up with a minority interest in a joint venture with a huge partner."

Decision To Sell

"Because Chiron was ready to reemphasize biotechnology, and because consolidation within the diagnostics industry had changed the game since Chiron's entry in 1995, the decision was made to sell the diagnostics business.

"Here is where it gets interesting," added Rossi. "Joint venture discussions with Bayer had already established a level of trust and mutual understanding about the business philosophies of both companies. That probably was an important reason why Bayer eventually decided to purchase Chiron Diagnostics."

Bayer paid a strong price for Chiron's diagnostics business. For $600 million in revenue, Bayer will pay $1.1 billion. Bayer is also licensing worldwide rights to market Chiron's proprietary research involving HVC and HIV. Bayer estimates that it may pay as much as $900 million in royalties to Chiron over the life of the contract.

This means Bayer will pay about $2 billion to Chiron for a combination of outright acquisition and technology licensing. Since Chiron controls 35% of the market for blood gas analyzers, laboratory executives throughout the United States will see change as Bayer takes over Chiron Diagnostics and begins folding it into the Bayer family of diagnostics products.

Joint Ventures

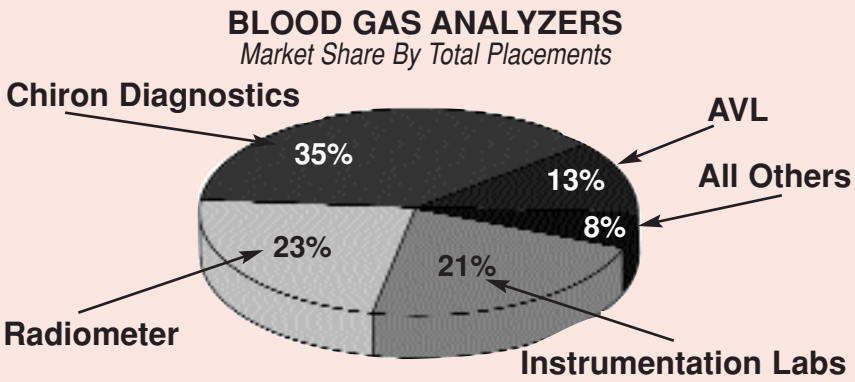
Chiron will still have a presence in diagnostics. The company is maintaining its joint ventures with **Ortho Diagnostics Systems, Inc.** of **Johnson & Johnson** and **Gen-Probe, Inc.** These ventures involve blood-screening products and generated $80 million in revenue and operating profit to Chiron last year.

One interesting side note to the Bayer-Chiron transaction adds further perspective about why Chiron divested itself of its diagnostics business. Even though diagnostics accounted for more than half of Chiron's total revenue, earnings after the divestiture are expected to remain virtually unchanged. The reason: operating profits from the diagnostics division were minimal.

Just as clinical laboratories saw their revenue base squeezed and operating margins shrink to razor-thin margins, so also has a similar thing happened to diagnostics companies. Consolidation within the industry has given big competitors more volume and more clout.

Bayer Buys Chiron Diagnostics

Bayer's acquisition of Chiron Diagnostics immediately makes it the largest player in the market for blood gas analyzers. Demand for product in this market segment is strong, with growth rates in excess of 10% for each year since 1993.



Source: IMV, Ltd., Diagnostics Division, 1998.

At the same time, consolidation of laboratory buyers (through commercial lab consolidation and hospital system consolidation) now gives buyers more power to drive down prices paid for instruments and reagents.

THE DARK REPORT sees conformation of several key trends from Bayer's acquisition of Chiron Diagnostics. First, steadily diminishing operating margins among diagnostics companies means that it is becoming increasingly difficult for small firms to expand market share. This is why second- and third-tier diagnostics companies find it difficult to finance aggressive growth.

Continued Acquisitions

Second, in the battle for market share, the diagnostics industry giants will continue to acquire lower-tier companies as a way to solidify market position, fill out holes in their product offerings, and obtain valuable new technology.

Third, clinical laboratories will find their vendor choices shrinking as this process plays out in the market. It is the consequence of consolidation of hospital systems and commerical laboratories. Although consolidation has increased the number of "larger" laboratories with buying clout, consolidation in the diagnostics industry means fewer instrument vendors to bid for its business.

Fourth, access to new diagnostic technology is a critical battleground for diagnostics companies. The explosion of viral load testing using PCR and NAD technology shows that future profits will not come from today's routine testing, but from tomorrow's value-added assays.

Because these new assays have greater clinical efficacy and value to physicians, patients and payers, reimbursement levels will reflect this value. That is the reason why clinical laboratories should track new diagnostic assays with the same diligence shown by the leading companies in the diagnostics industry. **TDR**

(For further information, contact Judy Rossi at 506-660-4875.)

AutoCyte Moves One Step Closer To FDA Approval

AutoCyte needs FDA decision to become newest competitor in automated cytology

CEO SUMMARY: Until now, AutoCyte has kept a relatively quiet presence in the automated cytology marketplace. That may soon change as the FDA takes action on the company's PREP™ and SCREEN™ products. AutoCyte expects these products will boost productivity and quality in cytology labs. AutoCyte's product positioning will be very different than its competitors: NeoPath, Neuromedical Systems, and Cytyc.

RECENT ACTIONS AT THE **Food and Drug Administration** (FDA) moved one **AutoCyte, Inc.** product forward and delayed approval on the other.

AutoCyte, based in Burlington, North Carolina, received a request from the FDA for additional information to support AutoCyte's premarket approval application (PMA) for the company's PREP™ product.

PREP is an automated system for preparing thinlayer Pap smears. AutoCyte was hoping that the FDA would make a positive decision on PREP in September, so the request for additional information will delay FDA action on that product.

News is more positive for AutoCyte's SCREEN product. "Clinical trials for SCREEN are completed and the FDA has all the necessary information required to act upon our PMA," stated James B. Powell, M.D., President and CEO of AutoCyte. "We now await notice from the FDA as to how they will proceed in evaluating the SCREEN PMA."

AutoCyte's SCREEN product is designed to work in tandem with its PREP system. SCREEN technology combines image analysis with classification software to screen Pap smears.

AutoCyte's intent to offer an integrated cytology system sets it apart from its competitors. "We had three goals in starting this company. It is what distinguishes us from other companies in the automated cytology field," said Dr. Powell.

> ***"Every area of the laboratory but cytology and histology has been helped by automation. That will change in the coming years as a stream of new automated products for these departments hits the market."***
>
> ***James B. Powell, M.D.***
> *President & CEO, AutoCyte, Inc.*

"Our first goal is to develop an automated liquid-based preparation system [mono-layer]," he continued. "We believe that removing unnecessary material from the Pap smear slide is essential to improve the

speed of the screening process, its quality, and its accuracy.

"Our second goal is to develop a unified, automated system of preparation and screening where individual components can work together as well as individually," noted Dr. Powell. "This gives laboratories maximum flexibility to incorporate our products into their particular situation."

System To Be Interactive

"The third goal is something we believe sets us apart from competing systems. We want our SCREEN system to be interactive with the cytotechnologist," said Dr. Powell. "We want to use the best features of automation to enhance and compliment the experience and skills of cytotechnologists.

"In looking at current work practices, we believe that automating the primary screening process has the best potential to enhance productivity and quality in the cytology laboratory. This is the step where a laboratory identifies slides as having either normal or abnormal cells.

"We are designing our systems to improve the speed of the initial sort between normal and abnormal," he added, "while at the same time improving quality and accuracy in the detection of abnormal cells on the individual Pap smears."

Cytology Will Consolidate

"The reason we took this direction is that we believe cytology will consolidate into larger processing centers. It will follow a similar path as the consolidation of clinical laboratory testing in recent years," predicted Dr. Powell. "As cytology consolidation occurs, it is necessary to provide cytotechnologists with tools which improve their productivity and their accuracy. That is the design philosophy behind our PREP and SCREEN products."

According to Dr. Powell, laboratories participating in development and clinical trials for PREP and SCREEN are accumulating information about the performance of the systems. "Early data indicates that cytotechs can become four or five times more efficient with our SCREEN system.

"For example, our systems are in use by a laboratory in Australia," he noted. "Its experience is similar to that of laboratories in the United States. Time trials done to date document that cytotechs average one and a half to two and a half minutes per slide with our SCREEN system, compared to eight to ten minutes per traditional Pap smear. Quality improves as well."

As the FDA evaluation process moves forward with AutoCyte's SCREEN PMA, a favorable decision by the government agency will permit a new competitor to enter the market for automated cytology.

Moment Of Truth

That will be the moment of truth for AutoCyte. Reimbursement for conventional Pap smears is currently at an uneconomically low level. Laboratory customers remain skeptical about the economics of acquiring and using automated technology which has entered the market to date.

Conventional Pap smear testing remains a difficult market niche, given malpractice trends, shortages of trained cytotechs and poor reimbursement. In contrast, automated cytology technology has the potential to eventually improve the reimbursement situation.

AutoCyte's product positioning strategy is unique. It will offer an integrated system capable of Pap smear preparation and Pap smear screening. It is interactive with cytotechs. Both characteristics set Autocyte apart from its three primary competitors in the automated cytology marketplace. TDR

(For further information, contact James B Powell, M.D. at 336-222-9707.)

Laboratory Industry Leader Offers Insights About Future

WHAT IS THE FUTURE for cytology and anatomic pathology? Dr. James Powell provides interesting observations about what lies ahead.

"Cytology and histology are the last areas of laboratory medicine to be addressed," stated Dr. Powell, President and CEO of Autocyte, Inc. "The effort to apply automation and productivity tools to cytology and histology has lagged behind those in other departments of the clinical laboratory.

"As operators of large clinical laboratories, we recognized the need to improve productivity in cytology and histology," he added. "It's an opportunity to apply new technologies to solve problems in these areas of the lab."

DARK REPORT clients should pay close attention to Dr. Powell's comments about future directions for cytology and the laboratory industry. Dr. Powell founded **Biomedical Laboratories** in Burlington. His laboratory was purchased by **Roche** and renamed **Roche Biomedical Laboratories**.

Roche later acquired **National Health Laboratories**, and the merged laboratory is known today as Laboratory Corporation of America. Dr. Powell was President and CEO of LabCorp until the beginning of 1997, when he resigned to pursue other business interests such as AutoCyte.

AutoCyte, Inc. was initially organized to develop automated cytology systems. But Dr. Powell and his executive team also have their eyes on the needs of anatomic pathology as well.

"We believe that cytology will increasingly be consolidated into larger-volume laboratories," stated Dr. Powell. "Given that fact, it is essential for our industry to develop tools which enhance the productivity, accuracy, and effectiveness of a cytotechnologist.

Dr. Powell believes that cytology automation will require cytotechs, but in different roles than simply screening Pap smears through a microscope. He also believes that new technology moving through the pipeline will affect the way cytology and other aspects of anatomic pathology are practiced.

"Imagine how emerging technologies could be applied to anatomic pathology," observed Dr. Powell, "As image capture systems become faster and more detailed, they should, for example, make measurement of the quantity of DNA speedy and accurate. New clinical studies indicate the quantity of DNA is directly relevant to cancer diagnostics and prognostics. Other tumor markers and HPV testing will be incorporated into the diagnosis of cervical cancer.

"Such technology would make it easier and faster for pathologists to evaluate specimens and make more precise and detailed diagnoses," he explained. "Such tools would permit pathologists to provide clinicians with quantitative and significantly more useful information about each patient.

"I fully expect that technology is going to eventually be applied to all areas of anatomic pathology," said Dr. Powell. "It will include reading specimens, archiving specimens and the data associated with them, performing tumor markers, DNA, and HPV analysis, and the teletransmission of pathology images and information.

"AutoCyte would like to be in the forefront of these developments," continued Dr. Powell. "Our primary business goal is to develop new tools to help cytotechnologists and pathologists improve clinical practices."

Healthcare Trends

Curse Of Consolidation Plagues Health Providers

Healthcare's billion-dollar behemoths struggling to achieve stability & profits

WITHOUT QUESTION, today's healthcare world is dominated by a single obvious trend: consolidation. The consequences of consolidation affect every segment of healthcare in the United States.

The commercial laboratory industry had the dubious distinction of being the first major segment of healthcare to undergo consolidation. Laboratorians are still dealing with its lingering effects.

Major cutbacks in the number of commercial laboratory sites, significant downsizing of med techs, and the creation of huge regional laboratory testing centers are the legacy of consolidation in the commercial lab industry.

The process of hospital laboratory consolidation is now in full flush. Activity to consolidate hospital labs is under way in almost every region of the country. Hospital laboratorians everywhere are dealing with the consequences of this pervasive trend.

Pathology Consolidation

The profession of pathology is only now embarking on its own consolidation journey. Within the pathology profession, consolidation is driven by hospital mergers, managed care contracting practices, and the arrival of pathology physician practice management (PPM) companies.

Whether the eventual consequences of pathology consolidation turn out to be good or bad has yet to be determined. Pathology consolidation is a market process which cannot be stopped, regardless of its impact upon individual pathologists.

Healthcare consolidation is an undeniable fact. That is why it is important for laboratory executives and pathologists to understand two key, but contradictory facts, about the consolidation process.

"Cottage" Providers

Fact One: *The American healthcare system is evolving towards integration of clinical services. This requires the fragmented marketplace of "cottage" providers to be consolidated into intergrated provider networks.*

Economics require managed care companies (MCO), hospitals, physicians, and ancillary providers to cooperate in providing comprehensive healthcare to patients. This can only be accomplished by preventing gaps in the patient's treatment (a fundamental flaw in fee-for-service healthcare).

Regardless of the organizational form chosen, the goal of HMOs and integrated delivery systems is to link physicians and providers in order to eliminate gaps in managing the health of individual patients.

That is why the day of the solo practitioner has ended. It is why large corporations strive to buy up hospitals,

physicians, laboratories, LTC facilities, and similar providers.

Fact Two: *Consolidation creates large size and more clout in the marketplace. But large size does not guarantee profits and success.*

It is important to understand the ramifications of this business concept. Consolidation is the dominant trend in healthcare. Consolidation creates size, market clout, and power with buyers. But large size is no guarantee of stability, sustained profits, and business success.

Too Big To Manage

THE DARK REPORT can list examples of this phenomenon in every segment of healthcare. **Columbia/HCA** grew from two hospitals in 1988 to 400 hospitals and $20 billion in sales by 1997. But, notwithstanding Medicare compliance and fraud issues, Columbia's executives found it too big to successfully manage and have begun shrinking the company.

Among MCOs and HMOs, the nation's largest companies posted immense losses during the last 18 months. **Oxford Health**, **Kaiser Permanente**, and **United Healthcare** posted losses, in millions, of $508, $275, and $565 million, respectively.

Posting Losses

In the PPM industry, industry leaders posted losses at an astonishing rate. **MedPartners** lost $840 million. **FPA Financial Management** entered bankruptcy. Even the darling of Wall Street, **PhyCor**, is writing off $92 million and telling analysts to expect weaker profits in coming years.

As laboratory executives and pathologists understand the contradictory nature of both facts about consolidation, it provides them with the key to developing the winning business strategy for their lab or pathology practice. The key is that service counts more than size.

Any successful business must meet and exceed the expectations of its customers day after day. Excellent customer service by laboratories and pathology practices insures a loyal customer base. It also permits labs and pathology practices to price services so as to maintain acceptable profits.

Consolidation is a market force which will not be stopped. But if laboratorians and pathologists understand the Achilles heel of these huge corporations, they can outcompete them. Healthcare is still a local business. The competitive edge is the exceptional service a local lab offers in its community **TDR**

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

Success Stems From Service, Not Because Of Huge Size

CONSOLIDATION AND HUGE SIZE do not guarantee profits and success. This creates an opportunity for smaller labs and pathology practices.

Excellent customer service is the critical success factor. Size generally inhibits billion-dollar healthcare behemoths from offering exceptional service. But nimble labs and pathology practices can excel at innovative customer service.

In San Diego, **Pathologists Medical Laboratories** (PML) operates a successful, independent commercial laboratory. Despite San Diego's brutal managed care market, PML's growth has been steady and the lab consistently makes money, unlike its other competitors in the state.

Cleveland's **Bayless-Pathmark** is a pathology practice which expanded from two pathologists to 22 in the last six years. It posts steady growth and profits through exceptional client service. And it does this without the "business experts" from a large PPM.

These are just two examples from **THE DARK REPORT'S** files of lab and pathology innovators. They prove that consolidated behemoths can be bested in the marketplace by nimble labs.

Pathologists Will Learn Income-Boosting Methods

Scottsdale is site for private symposium dedicated to enhancing pathology profits

CEO SUMMARY: Reimbursement for pathology services continues to decline. Despite this fact, savvy pathologists throughout the country are steadily increasing their take-home income. Their proven methods and secret strategies will be the theme of the* Private Pathology Income Symposium. *This year's event will teach participating pathologists how to preserve and enhance their practice income.

REIMBURSEMENT FOR PATHOLOGY services continues to decline. Despite this fact, a select group of savvy pathologists are steadily increasing their take-home income.

Their proven methods and well-kept secrets for boosting pathology income will be shared at the upcoming *Private Pathology Income Symposium* in Scottsdale, Arizona.

Scheduled for November 13-14, 1998 at the plush **Sunburst Resort**, the private symposium is a direct consequence of the precedent-shattering event produced for pathologists by THE DARK REPORT in 1997.

"Most pathologists would probably agree that the subject of pathology compensation is taboo at public meetings," stated Robert Michel, Editor-In-Chief of THE DARK REPORT. "Last year we decided to break that taboo. We believed it was time that pathologists learned the money secrets of the pros.

"Last November we convened a panel of pathology's shrewdest minds in business and finance," he said. "We then invited like-minded pathologists to participate in candid, free-wheeling sessions about how to preserve and enhance the money made by pathologists. We were careful to exclude hospital administrators from attendance to protect revelations about the nitty-gritty of negotiating hospital-based pathology contracts."

Boosting Pathology Profits

"It was like putting various ingredients for a delicious gumbo into the pot and then turning up the heat," recalled Michel. "That first *Private Pathology Income Symposium* energized pathologists and faculty alike with easy strategies and methods for boosting profits and enhancing pathology income.

"Pathologists at this pioneering event told us it was the single most powerful source of knowledge about protecting their money they'd ever experienced," he recalled. "They insisted that we hold another private income symposium and that it be expanded into two days."

The upcoming *Private Pathology Income Symposium* will be useful to pathologists at any level of financial

sophistication. "Participating pathologists will discover that most of these money strategies are simple to learn. As pathologists gain experience and familiarity in using these strategies, they become more subtle in their implementation."

Pathologists attending the symposium will learn to understand why Medicare risk contracts offer them only "80%" of Medicare fees for AP services. More importantly, they will learn where the real money is in Medicare risk contracting and how to get their fair share.

"This symposium will teach pathologists why disease management is more than a buzz word," stated Michel. "We have Richard Adelson, National Sales and Marketing Director for **IMPATH, Inc.** coming to discuss how and why community hospital-based pathologists should develop their brand of anatomic pathology disease management services. In the future, this will be the source of profits from anatomic pathology.

"Even more exciting is the information about how pathology practices can develop value-added services in clinical pathology... and get paid for them! We are pleased to have a pathology group from a highly-respected hospital share with the symposium its experience at providing clinicians with test reports that include a professional clinical pathology component.

"Clinicians reacted enthusiastically to this information," continued Michel, "More importantly, this pathology practice now earns seven figures annually from its clinical pathology professional billings. MCOs recognize the value of these professional services and are reimbursing for them.

"These are just some of the breakthrough income and reimbursement techniques which pathologists will learn and master during the symposium," he added. "Experts in pathology practice management, pathology law, and pathology contracting will teach little-known, but highly effective methods for minimizing risk and maximizing practice income."

Other topics to be covered at the *Private Pathology Income Symposium* include: evaluating pathology PPM offers for your practice; market forces driving pathology compensation and effective ways to counter them; finding lost money in your billing department that your manager doesn't even know exists; and pathology contract strategies in the hospital and HMO worlds.

As was true of last year's symposium, attendance is strictly limited to 100 pathologists and their business advisors. This insures open, candid discussion of the issues and permits one-on-one dialogue between any participant and the symposium faculty.

"This is the single most important event for any pathologist concerned about his or her standard of living and financial future," observed Michel. "It is an unusual opportunity to learn from successful professionals. The confidential setting makes it possible to discuss practical details about how to apply this knowledge in any pathology practice setting." TDR

(For further information and to register, call THE DARK REPORT at 800-560-6363 or www.darkreport.com)

Private Pathology Income Symposium
AGENDA

FRIDAY, NOVEMBER 13, 1998

8:30 am-9:30 am: ***Market Forces Driving Pathology Compensation & Income;*** Robert Michel, Editor, THE DARK REPORT.

9:30-10:30 am: ***Twin Trends In Medicare Will Diminish Pathology Compensation... And AP Specimens***; Jake Dougrey, Practice Administrator, Pathology Consultants & Associates.

10:45-11:15 am: ***Medicare Reimbursement Changes To Pathology & Their Impact;*** Joe Plandowski, Principal, The Lakewood Consulting Group.

11:15-12:30 am: ***Using Market Trends To Shape Money-Making Pathology Practice Business Strategies;*** Boone Emmons, Strategic Facilitator; Workshop.

1:30-2:30 pm: ***Developing Clinical Pathology Into A Value-Added Service... and Getting Paid For It!*** Elizabeth Van Cott, M.D., Director, Coagulation Labs, Massachusetts General Hospital.

2:30-3:30 pm: ***Anatomic Pathology, Disease Management, and Value-Added Service: Pathology's Next Wave Has Arrived;*** Richard Adelson, Sr VP, Sales & Marketing, IMPATH, Inc.

3:45-4:45 pm: ***Creating Value From Anatomic Pathology and Clinical Pathology: Services;*** Kerry Kaplan, Facilitator; Workshop.

4:45-5:45 pm: ***Summary of Day One Learning and Panel Discussion;*** Robert Michel with Facilitators Emmons & Kaplan.

Friday Evening: Reception and Cocktails

SATURDAY, NOVEMBER 14, 1998

8:30 am-9:30 am: ***Financial Strategies For Maximizing Pathology Practice Profits;*** Rusty Senac, Administrator, Brown & Associates.

9:30-10:30 am: ***The Pathology Practice As A Real Business: How Partners Can Make Money;*** Michael Walsh, M.D., Chairman, Dept. of Pathology, ProMedica Health System.

10:45-11:45 am: ***Seizing Business Opportunities: Sure-Fire Ways That Pathology Practices Can Boost Revenue and Partner Profits;*** Boone Emmons; Workshop.

11:45-12: 30 am: ***Everything You Should Know About Pathology-Based Physician Practice Management (PPM) Companies;*** Joe Plandowski, Principal, The Lakewood Consulting Group.

1:30-2:30 pm: ***Lost Money In Your Own Practices: Why Billing And Collections Is The Biggest Moneyloser For Most Pathology Practices;*** Al Sirmon, CFO, Pathology Service Associates.

2:30-3:30 pm: ***Contract Strategies In The Hospital And HMO Worlds;*** Jane Pine Wood, Attorney, MacDonald, Hopkins, Burke & Haber.

3:45-4:45 pm: ***Finding Huge Pots of Dollars Through Better Management Of The Pathology Practice;*** Kerry Kaplan, Workshop.

4:45-5:45 pm: ***Program Summary and Panel Discussion;*** Robert Michel

Call 800-560-6363 To register or for information!

Unilab's Bid To Buy Meris Will Shake Up California

California's commercial labs soon to undergo further consolidation if this sale is completed

CEO SUMMARY: More laboratory overcapacity may be removed from the California marketplace if Unilab purchases Meris Laboratories. Unilab's offer to buy Meris must be cleared by the bankruptcy court and other bidders may surface during the coming weeks. These events are a reminder that financial pressure on the clinical laboratory industry continues to force change and that lab values are declining.

CALIFORNIA'S ROSTER of commercial laboratories is poised for radical change in the coming months. Catalyst for this change is **Unilab Corporation's** bid to purchase **Meris Laboratories Inc.** from its Chapter 11 bankruptcy case.

Meris, based in San Jose, California, disclosed on September 18 that it had signed a definitive agreement for Unilab to purchase "substantially all the assets (including the customer list)" of Meris.

Purchase terms validate the decline in recent years in the market value of clinical laboratories. The agreement to purchase calls for Unilab to pay $16.52 million. Revenues at Meris are currently around $30 million per year.

Subordinated Note

Payment is to be in the form of a convertible subordinated note for $14 million. This note bears interest at 7.5% per annum, is due in eight years, and is convertible at $3.00 per share. Unilab will issue a $2.52 million note for the balance of the purchase price, payable in equal installments over 72 months.

"This is the first formal purchase offer for Meris and it has been submitted to the bankruptcy court," said Philip Tremonti, President and CEO of Meris. "The bankruptcy court has now begun an open bidding process for Meris Laboratories."

Tremonti expects that other bidders will turn up. "Unilab has established a fair bid from which others will have to base their bids," he noted. "The court will allow the bid process to continue for about 21 days. Sometime in late October the court will weigh all bids and make a decision."

Meris' financial problems have been severe in recent years. For fiscal 1996, losses totaled almost $30 million dollars, an amount approximately equal to the laboratory's annual sales.

Things did not improve. "1997 and 1998 were at least as bad, if not worse," Tremonti said. "These losses reflect the severe declines for laboratory test reimbursement in California during the same period."

Continuous losses during the last three years did not prevent Meris from continuing business operations. Regular infusions of cash came from Wall Street investors such as **Cereberus Partners**.

Cereberus likes to invest in distressed companies and wants to take an active role in making these companies profitable. Observers familiar with the situation believe Cereberus has learned some unforeseen lessons about the economics of the clinical laboratory industry.

No such misconceptions about the viability of the lab industry exist at Unilab. During the last several years Unilab was forced to take dramatic steps to staunch huge losses and restore financial stability to California's largest clinical laboratory system.

"Two reasons led us to consider this acquisition," stated Richard Michaelson, a Unilab Director and former CFO. "First, through 1997 and into 1998, Unilab's margins have appreciably strengthened, giving us the confidence in the strength and stability of our core operations to responsibly target additional growth opportunities.

"Second, the seller's perspective of a distressed laboratory sale has changed," he continued. "That created the opportunity to negotiate a sale with price and terms that more closely reflect current market conditions. Unilab's offer to buy Meris is based upon something greater than their going EBITDA rate (Earnings Before Interest, Taxes, Depreciation, and Amortization). It reflects a valuation that Unilab feels can accrue substantial value to its shareholders."

Unilab's interest in acquiring Meris stems from two facts. One, Unilab likes the market areas served by Meris and the loyalty of Meris' clients. Two, Unilab's northern California core laboratory is located less than two miles from the Meris central laboratory. That makes consolidation and integration of the two operations much easier.

Hamstrung By Problems

"Unilab has always viewed Meris as a quality laboratory operation hamstrung by problems within the corporate shell," observed Michaelson. "Doctors served by Meris generally view the laboratory as a good operation. Meanwhile, the multi-year battle between Meris executives Chris Reidel and Steve Kass consumed millions of dollars in settlements and legal fees, while distracting management's attention away from the day-to-day business operations."

Phil Tremonti offers a fact which seems to confirm the operational stability of Meris during the multi-year crises which landed the company into bankruptcy. "Our specimen volume count is cur-

Is Bio-Cypher Labs Next On The Chopping Block?

CALIFORNIA'S OTHER TROUBLED lab company is Bio-Cypher Laboratories, Inc., headquartered in Sacramento.

Formerly known as Physicians Clinical Laboratories (PCL), Bio-Cypher was acquired by J. Marvin Feigenbaum after PCL filed Chapter 11 bankruptcy in late 1996.

From PCL's peak revenues of $110 million in 1995, Bio-Cypher has dwindled to around $65 million in annual sales. Reports are that management turnover within Bio-Cypher has been extensive at all levels within the lab.

Cash flow problems within the reorganized laboratory continued the drawdown of operating capital after the bankruptcy was discharged. Bio-Cypher used its billings receivables to secure a $10 million receivables facility from **Daiwa Securities America, Inc.** in late 1997 as one method to maintain working capital.

Apparently more capital was needed. In June 1998 Bio-Cypher borrowed $4 million from one of its creditors, Oak Tree Capital Management.

Should Bio-Cypher's negative cash flow continue, observers believe that Bio-Cypher will become the next laboratory organization in California to come into play, probably through sale or bankruptcy. If that occurs, it will have a greater impact on California's commercial lab marketplace than the sale of Meris.

rently within 10% of our 1995 level. Yet reimbursement has dropped significantly during the same time. This means we continue to perform almost the same number of laboratory tests, but get paid much less than was typical three years ago."

Financially Troubling Trend

"Another financially troubling trend is the cost of billing for laboratory services," he continued. "A multitude of managed care plans, increased claims rejection by payers, and medical necessity requirements all add cost to the billing process. Our average billing cost now approaches $5.00 per accession."

What makes the Meris case worth watching is that Unilab's offer may precipitate a realignment of commercial laboratory competitors in California. Only a few laboratories remain in the state.

Unilab, currently at $214 million per year in sales, is the 800-pound gorilla in California. **SmithKline Beecham Clinical Laboratories** (SBCL) and **Laboratory Corporation of America** have significant presence, although each does much less testing in the state than Unilab.

Emerged From Bankruptcy

Bio-Cypher Laboratories of Sacramento (formerly **Physicians Clinical Laboratories**) emerged from Chapter 11 bankruptcy in 1997 with new owners and about $65 million per year in sales (down from a peak of $110 million in 1995).

Rounding out California's major laboratory players is **Quest Diagnostics Incorporated**, with a clinical laboratory operation in San Diego that does around $15 million per year in testing. Quest also operates its **Nichols Institute** division in San Juan Capistrano, but most testing at that location is reference and esoteric work.

The court will not disclose all additional bidders for Meris until 72 hours before the bidding window closes in late October. Any of the laboratories mentioned above could enter a bid. Another potential bidder is **Oak Tree Capital Management**, an investment company whichs hold sizeable portions of debt and equity in Bio-Cypher.

The court's open bid process will reveal how much change has taken place in the business philosophy of commercial laboratory executives. If Unilab has accurately assessed Meris' true market value and entered an appropriate bid, then any effort by a competing laboratory to outbid Unilab with a significantly higher price would be evidence that some lab executives are still willing to incur losses to grab market share.

Unchallenged Bid

If the Unilab bid stands unchallenged, that may be a sign that lab competitors in California have finally become unwilling to make unprofitable investments simply to become larger.

No matter who ends up buying Meris, the sale of Meris validates a dominant market trend identified by THE DARK REPORT. That trend is the reduction of laboratory overcapacity. Any buyer of Meris can only do one rational thing with the company: close down its laboratory and consolidate the Meris clients and operations into the buyer's existing laboratory infrastructure.

Lab executives should follow the aftermath of the Meris sale. California has already seen a huge reduction in laboratory overcapacity. Bankruptcies and downsizing at all the major labs are bringing capacity in line with demand. At some point equilibrium will be reached. When that occurs, the prices paid for laboratory testing should firm up and possibly begin to increase.

Further, these transactions give existing commercial laboratory owners a good indication of current market values for their laboratories. **TDR**

(For further information, contact Philip Tremonti at 408-452-3100 and Richard Michaelson at 201-525-1000.)

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Just days ago, **Bayer AG** announced one of the largest drug-discovery alliances ever created. Bayer will pay **Millennium Pharmaceuticals, Inc.** $465 million. In return, over a six-year period, Millennium will use genomics techniques to identify cures for various diseases. Millennium must deliver 225 drug "targets" or proteins that may be useful in designing drugs.

MORE ON...BAYER:
This deal is based on the emerging branch of science called "pharmacogenomics." *(See TDR, September 8, 1998.)* Bayer is placing a huge bet that Millennium can identify blockbuster drugs. Even though the emphasis is on new drugs, expect this alliance's work to result in new diagnostic assays.

The **U.S. Labor Department's** Producer Price Index reported that wholesale prices for acute care hospital services rose .01% for August and .07% for the 12-month period ending in August. It demonstrates that hospital cost increases are not driving HMO premium increases.

MORE HMOS exiting Medicare Risk Business

First it was **Aetna/U.S. Healthcare**. On September 1 the company announced it would launch a major scale-back of of its Medicare HMO operations in six states, affecting 58,000 seniors. Aetna will continue to provide coverage to 469,000 seniors in its remaining Medicare HMO plans.

Next was **United Healthcare Corp.**, base in Minnetonka, Wisconsin. Just last week the managed care giant revealed its intent to withdraw from 86 of the 206 counties where it operates Medicare health plans. The move affects 59,000 of the company's 440,000 Medicare beneficiaries.

ADD TO...MEDICARE:
Expect a coming clash between HCFA and the managed care industry on Medicare risk plan reimbursement levels. Managed care companies will withdraw from counties where the prospective Medicare reimbursement is deemed inadequate to provide proper coverage. This battle affects clinical labs, because the growth of Medicare risk plans will diminish the amount of Medicare lab testing which is reimbursed under fee-for-service schedules.

PharmChem Laboratories, Inc. of Menlo Park, California just snagged a big drug testing contract. Starting October 1, it will provide drug testing services to the **National Institute of Justice's** (NIJ) Research Program called "Arrestee Drug Abuse Monitoring" (ADAM). It is a one-year contract with a three-year renewal option. PharmChem President and CEO Joe Halligen said the contract has a projected maximum potential of $8 million over its four-year life.

Look for an official announcement soon that one of the nation's largest managed care companies has signed an exclusive national laboratory testing contract with one of the three blood brothers.

That's all the insider intelligence for this report.
Look for the next briefing on Monday, October 19, 1998

THE DARK REPORT

UPCOMING...

- *Automated Cytology Reimbursement: Facts Behind The Sales And Marketing Fiction.*
- *Overlooked Regional Laboratory Network Finds Managed Care Contracting Success.*
- *More On California's Coming Realignment Of Commercial Laboratory Competitors.*
- *Pathology Practice Consolidation Delivers Surprising Benefits To Pathologist Income.*