

From the Desk of R. Lewis Dark...

THE **RED** DARK REPORT

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

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Commentary & Opinion by...

R. Lewis Dark

Founder & Publisher



These Leaders in Lab Management Took Risks

BY NOW THE NEWS IS GETTING OUT. Hospital laboratory administrators and pathologists are learning there now exists a management approach that cuts the average turnaround time from order to verified result by as much as 50% in as few as 12 weeks!

If that's not enough, this management approach will simultaneously reduce trained technical labor in routine, high-volume test areas by up to 50%, even while boosting the quality and integrity of the test results generated. The management approach I speak of is "Lean." Long used in corporations outside healthcare, it has recently been adopted by an intrepid handful of hospital laboratory management leaders. THE DARK REPORT provided first details of their break-through management results in its last issue. (*See TDR, September 8, 2003.*)

I would like to put these individuals in the spotlight for a moment. What sets them apart from their peers is their willingness to take a single risk: They were willing to take Lean management methods and introduce them into their laboratory organization by tackling, as a first project, the high-volume core testing portion of their laboratory. Within the lab industry, many laboratory directors and pathologists looking at the same decision in their own lab would characterize it as a "go-for-broke," high-risk decision that could wreak havoc within the lab—if something went wrong. Until now, lab managers have chosen to follow the "safe" course and keep the status quo.

But not these intrepid lab leaders. I'm proud to acknowledge the following: Paul Gotcher, President, **DSI Laboratories, Inc.** of Fort Myers, Florida; Rick Panning, President, Laboratory Services Division, **Fairview Health Services**, Minneapolis, Minnesota; Leo Serrano, Director of Laboratory Services, **West Tennessee Healthcare**, Jackson, Tennessee, and Ron Brown, Laboratory Administrator, **Evergreen Community Hospital**, Kirkland, Washington. During the first six months of 2003, these individuals launched a two-fold project. First, to teach their laboratory how to apply the principles of Lean management. Second, to use Lean to restructure how high-volume testing is performed in their laboratories.

That line from *Star Trek* is an apt description, "to boldly go where no man has before." Each of these individuals assumed great risk to improve outcomes by factors of 40%, 50%, and more, by their willingness to learn and utilize a management philosophy foreign to the clinical laboratory industry. My congratulations for showing the rest of us the way!

TDR

Chapter 11 Bankruptcy Filed by IMPATH, Inc.

*Troubled anatomic pathology company
hopes to buy enough time to find a buyer*

CEO SUMMARY: *To the surprise of very few, IMPATH, Inc. filed for Chapter 11 bankruptcy protection. During 2003, most of IMPATH's key executives departed as different problems within the company became known. IMPATH's new executive leadership is dealing with a host of difficult issues. Caught up in this situation is Tamtron, the division of IMPATH which sells IT systems to pathology groups.*

A N IGNOMINIOUS END MAY BE NEAR for a company that pioneered a unique new business model in anatomic pathology services.

IMPATH Inc. filed a Chapter 11 bankruptcy petition in the Southern District Bankruptcy court of New York on September 29. Among other things, it hopes to gain court approval to access a \$15 million Debtor-in-Possession (DIP) line of credit provided by **Fleet National Bank**.

The company claims there will be no interruption in services provided to its clients. However, IMPATH has not made any statements about how the Chapter 11 bankruptcy filing may affect pathology group customers using its **Tamtron PowerPath®** pathology information system. In January

2002, IMPATH purchased Tamtron. (See *TDR*, January 28, 2002.) PowerPath is used in at least 350 pathology sites, so any disruptions caused by the bankruptcy action which directly affect this operating division could be troublesome for some pathology group practices.

The serious magnitude of IMPATH's problems is reflected in the fact that it has been unable to file a financial report for second quarter 2003. As well, throughout recent months, IMPATH has laid off staff from various facilities and laboratories. At a minimum, this employee turnover disrupts the service continuity clients experienced with IMPATH during the time they have referred cases to the New York-based company.

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There are reports that clients of IMPATH have begun to switch to other sources. Competitors like **US LABS, Inc.** report strong growth in new client accounts during the year. But since IMPATH has not filed its most recent quarterly report, it is difficult to estimate how much fall-off in business the company has experienced, particularly in recent months.

Finding A Buyer

In filing bankruptcy, the company has publicly stated that a primary goal is to find a buyer. However, that may prove difficult. IMPATH has disclosed financial irregularities in how its business was conducted in past years by the former executive team. But the specifics of these financial irregularities have not been publicly disclosed. If they include compliance violations with government health programs such as Medicare and Medicaid, then any buyer might face substantial financial exposure for these “past sins.” It would be difficult for IMPATH to indemnify a buyer from such claims, since it has inadequate net worth.

Mounting Legal Bills

Legal expenses at IMPATH will be considerable in the coming months. Along with its Chapter 11 bankruptcy filing, the company has been served with multiple lawsuits on behalf of investors. These lawsuits claim that investors were misled by the statements and actions of executives at IMPATH.

Another source of legal expenses will be the formal investigation by the **Securities and Exchange Commission (SEC)**. On September 9, IMPATH disclosed that the SEC had sent notification that it “has issued a formal order of private investigation to determine whether there have been violations of the federal securities laws and regulations.”

During most of the 1990s, IMPATH was a high-flying company. Its business plan was simple and different. It offered services that helped community hospital-based pathologists diagnose “difficult-to-diagnose” cancers.

At a time when most academic center laboratories could take up to three weeks to provide complex diagnostic tests on a case, IMPATH provided a faster answer. Its strategy was “send us the specimen and the supporting information. In 48 hours we will provide a diagnostic report and return all the submitted materials.”

Faster TAT Was A Benefit

Many pathologists found this fast turnaround time appealing. The proof is in IMPATH’s fast growth in case volume. When IMPATH did its IPO (initial public offering) in the mid-1990s, its annual revenues were about \$25 million. By 2002, it ended the year with revenues of \$226 million.

IMPATH’s Cinderella story began unraveling about two years ago. As its stock price posted hefty gains, more financial analysts began to study the company and recommend its stock. IMPATH had an unusually high DSO (days sales outstanding). Its accounts receivable and bad debt accounting were different from other laboratories.

This caught the attention of financial analysts. More than one analyst concluded that IMPATH was manipulating its accounting. From that point on, scrutiny by the investment community increased. With additional scrutiny, more questions were raised about other aspects of IMPATH’s business.

Within the laboratory community, IMPATH was known to be aggressive about many of its sales, marketing, and compliance policies. Its bankruptcy filing may be the reckoning that some lab industry observers have long believed would occur.

AP's "High & Mighty" Firms Hit Tough Times

Three public anatomic pathology firms undergo individual transformations

CEO SUMMARY: *In the years between 1995 and 2002, public companies AmeriPath, DIANON Systems, and IMPATH built revenues and profits at a blistering pace. During this time period, these three firms captured enough market share to do almost \$1 billion of anatomic pathology business in 2002. But that run of business success has ended. Each of the three companies has been dealing with unique circumstances.*

By Robert L. Michel

IN CASE ANY PATHOLOGIST HAS FAILED to notice, the past 12 months have not been kind to the three public companies organized to provide anatomic pathology services across the nation.

During the years 1995 to 2002, **AmeriPath, Inc., DIANON Systems, Inc., and IMPATH, Inc.** posted amazing year-over-year rates of growth in specimen volume, revenues, and profits. In watching this occur, it was my belief that the success of these companies in the pathology marketplace was evidence that the traditional market for anatomic pathology was changing.

Adverse Impact Of Change

These market changes would increasingly have an adverse effect on local pathology group practices—if they didn't implement a strategic response. That is why THE DARK REPORT was first to describe these new market characteristics and provide useful business intelligence to pathology groups, allowing them to develop

effective business strategies to counter these trends.

But every run of luck and every string of victories must eventually end. After five to seven years of rapid and unbroken growth, each of these three national pathology companies has "hit the wall" in some fashion.

For AmeriPath, its business model did not generate enough cash and its share price was not performing well enough to meet the company's strategic needs. In order to infuse more capital in the company, AmeriPath structured a sale to **Welsh, Carson, Anderson, & Stowe**, a private equity company based in New York City. This transaction was completed earlier this year and AmeriPath became a private company. (See TDR, March 3, 2003.)

For DIANON Systems, Inc., it was the decision of the shareholders to sell the business to maximize its value. Last fall, **Laboratory Corporation of America, Inc.** became the willing buyer and paid almost \$600 million to

acquire DIANON and its revenue base of \$190 million per year. (*See TDR, November 18, 2002.*)

With IMPATH, Inc., problems that placed it in bankruptcy this week have more to do with management decisions and corporate philosophies than adverse changes in the laboratory marketplace. (*See pages 2-3 in this issue.*) In fact, competing companies which copied its business model (offering lab services for difficult-to-diagnose cancers to community hospital-based pathologists and oncologists) continue to grow and prosper.

Radical Changes

So, in the space of 12 months, each of the three national anatomic pathology companies has undergone some type of radical restructuring. AmeriPath continues as a private company. DIANON Systems is being rapidly absorbed and consolidated within LabCorp. IMPATH's specific fate is still unknown, but there it is highly unlikely that it will survive in its current form.

My assessment is that the events transforming AmeriPath, DIANON, and IMPATH are unrelated to the marketplace for anatomic pathology services. The evolution in healthcare and physician needs which supported the specimen growth of these three companies during the past five to seven years remains on course today.

Office-based physicians are increasingly willing to use anatomic pathology services offered by national lab companies. This is a change in physician referral patterns which must be recognized by anatomic pathology groups.

Local pathology groups now have national competitors attempting to capture anatomic pathology (AP) specimens originating in physicians' offices. This is a battle and the compe-

tition is fierce. Local pathology group practices must recognize this fact and develop effective business strategies. Failure to do so will contribute to a possible decline in their core business.

It would be a mistake for pathology groups to interpret the changes at AmeriPath, DIANON Systems, and IMPATH as proof that the sales and marketing models used by these companies are no longer relevant. The restructuring activities at these three companies in the past 12 months are directly linked to the decisions and capabilities of their management teams, not because of any sudden shift in the marketplace itself.

To the contrary, studies of the anatomic pathology marketplace by experienced business minds validate the opportunity to build a profitable business by marketing AP services directly to physicians' offices. That is precisely why LabCorp paid more than one-half billion dollars to buy DIANON Systems. It is why **Quest Diagnostics Incorporated** is hiring pathologists and expanding its AP sales and marketing team.

New, Different Approach

I predict that we will see several well-financed new companies enter the national marketplace for AP services during the next 24 months. If these companies are well-managed, they should have the same kind of success that AmeriPath, DIANON Systems, and IMPATH enjoyed between 1995 and 2002.

For local anatomic pathology groups, the challenge will be to wake up all the pathologist-partners and develop business strategies which protect market share and generate the cash flow group practices need to acquire new diagnostic technology and offer it to local physicians.

TDR

Contact Robert L. Michel at 512-264-7103.

Entrepreneur Offers Private Pay Autopsies

Ongoing unmet demand for autopsies creates significant business opportunity

CEO SUMMARY: *For the past 14 years, a non-pathologist entrepreneur has enjoyed a growing business in offering autopsy services to clients willing to pay out-of-pocket. By design, the business is limited to the Southern California region. But demand in that region is enough to regularly engage the autopsy services of six pathologists. Here's a look at the key strategies that support this business concept.*

OVER THE PAST DECADE, autopsies became a casualty of managed care's cost-cutting mentality. With few private payers willing to reimburse for autopsies in most situations, the pathology profession shifted its attention to other health services.

Despite the impact of managed care, however, the private pay market for autopsies can be accurately described as "alive and well." However, few in the pathology profession consider the unmet demand for private-pay autopsies to be a business opportunity. Evidence points to the contrary.

One example is entrepreneur Vidal Herrera. During the past 14 years, his Los-Angeles-based business, **1-800-AUTOPSY**, has performed thousands of autopsies, primarily in the Southern California area. A non-pathologist, Herrera sustained a career-ending major back injury while working as a Field Deputy Coroner for the **Los Angeles County** Chief Medical Examiner.

Following his injury, Herrera knew he wanted to continue his career in

forensics. In 1988, he founded 1-800-AUTOPSY to provide autopsy services primarily to private-pay clients and hospitals that needed his assistance in performing autopsies.

Without a formal marketing program, Herrera's autopsy business grew steadily. "Currently we complete between 400 and 600 procedures each year," stated Herrera. "About 90% of these are autopsies and the balance is mostly procurement and/or retrieval of tissue and organs. We typically charge a total of between \$2,000 and \$3,000 for an autopsy.

"Our customer pays the pathologist who performs the autopsy directly," he added. "The fee collected by 1-800-AUTOPSY averages between \$1,300 and \$1,500. For this, we arrange a site and a pathologist to perform the autopsy, take photographs, collect body fluids, arrange for X-Rays, deliver the final report, and coordinate transportation of the body, as necessary. We do not bill insurance companies. In general, Medicare and most payers consider an autopsy procedure to be unnecessary."

Herrera, President of 1-800-AUTOPSY, says the demand for autopsy services is substantial. "Our telephone starts ringing as early as 5:00 o'clock in the morning as people on the East Coast call us. Phones continue to ring late into the evening," he said. "Many of our callers are family members of someone recently deceased. For a variety of reasons, they want a medical opinion as to the circumstances of death. Interestingly, concerns about medical malpractice are a major factor in many autopsy requests."

In fact, by his own estimate, Herrera estimates that he only provides autopsy services to less than 10% of the requests fielded by his company.

The decline in the number of autopsies done annually in the United States provides insight into the demand which sustains Herrera's business. "In the United States, as recently as 1970, the autopsy rate for all deaths performed at no cost to the family was 50%," he observed. "Today, an autopsy is performed on less than 3% of deaths nationally. Because of changes in health insurance guidelines during this time period, there is virtually zero funding to pay for autopsies performed in hospitals."

Even though insurance reimbursement for autopsies has evaporated, the legitimate need for autopsies continues. Herrera says there is one primary reason that family members are interested in paying for autopsies. "Not surprisingly, most requests are related to concerns about malpractice," he observed. "That's not to say they all end up in litigation, but the interest in having answers spurs many calls."

1-800-AUTOPSY has grown between 10% and 15% annually. Its annual revenues reach into the high six figures, independent of the professional fees directly paid to pathologists who perform the autopsy procedure. Six pathologists perform the majority of procedures for 1-800-AUTOPSY. Five are full-time, hospital-based pathologists.

Pathologists associated with 1-800-AUTOPSY must be willing to work on call. "We get many requests from pathologists to do autopsies for our company," explained Herrera. "But most of these physicians only want to work on a certain day between certain hours. Unfortunately, that is not possible in this business. I tell them 'there are no appointments for death. When death happens, our physicians must respond, regardless of the time of day.' That requirement dissuades many pathologists interested in doing work for us."

Travel is another barrier to the expansion of Herrera's business. "In general, our pathologists charge \$200 per hour for their services. We restrict our travel and find it less expensive to ship bodies to us than to travel outside the state to perform an autopsy," he stated. "But the downside to that is we lose lots of business because we do not have the ability, in regions outside of Southern California, to do autopsies."

Plenty Of Requests

In fact, by his own estimate, Herrera estimates that he only provides autopsy services to less than 10% of the requests fielded by his company. "Daily we get calls from all over the United States. At this point, we turn down nine of every ten requests, primarily because we decline to travel outside our service area to perform the autopsy," he noted. "But I want to point out that, even in declining this work, we have grown between 10% and 15% per year for more than a decade. That shows how

Popular Forensic Television Shows Use Herrera's Lab Facility for a Backdrop

HAVING BUILT A STATE-OF-THE ART autopsy facility, 1-800-AUTOPSY fell victim to a bureaucratic mistake which led to its starring role in several forensic television shows.

Following the purchase of a building, the City of Los Angeles issued eight permits to allow 1-800-AUTOPSY to upgrade it to modern standards with the stated purpose of performing autopsies. Two weeks prior to the completion of renovations, the city realized it had made a major mistake. The area where the building is located had been rezoned five years prior and its use for autopsies violated the current zoning. It successfully blocked 1-800-AUTOPSY's use of the building for that purpose.

With its building turned into a lemon, Vidal Herrera, President of 1-800-AUTOPSY, filed a lawsuit for damages against the city. However, the opportunity to make lemonade from the "lemon" building arrived from an unlikely source: Hollywood!

Some of the hottest television shows today involve forensic science. Hollywood producers called 1-800-AUTOPSY looking for an autopsy laboratory that could be used as a set. As it turned out, the equipment in the laboratory was also needed for filming.

Studios like **Sony**, **Warner Brothers**, and **Universal** have used the 1-800-AUTOPSY building for television programs like: *CSI*, *CSI Miami*, *Crossing Jordan*, *Boom Town*, and *Dragnet*. In addition, **The Discovery Channel** did segments with a doctor affiliated with Herrera, including a review of Marilyn Monroe's death, an analysis of shark bites, and a review of Princess Diana's autopsy reports and her death.

"It was a surprise to experience the glamour that television now associates with forensics," stated Herrera. "However, it is frustrating that we have this well-designed laboratory for performing autopsies and a bureaucratic mistake by the city prevents us from using it for its intended purpose."

much opportunity exists in the private-pay autopsy field."

To meet this unrealized business opportunity, Herrera is developing a franchise program. The goal would be to replicate the Los Angeles-based 1-800-AUTOPSY operation in other cities. Primary candidates for franchising are not pathologists. They are pathology assistants, autopsy technicians, and funeral directors/embalmers. "Physicians tend to be motivated in their practice of medicine," explained Herrera. "In contrast, pathology assistants already tend to be organizers and have a knack for orchestrating the needed services between families and pathologists performing the autopsy."

Within the academic medical community, there is recognition that Herrera is keeping a "dying art" alive. "Each year, as new residents begin pathology rotation, I am often asked to demonstrate proper classic techniques for performing physical autopsies to the first-year residents," explained Herrera. "I do this for the medical programs at **USC**, **Cedar-Sinai Medical Center**, and for the **Veterans' Administration** in West Los Angeles and Long Beach."

Herrera is committed to the field of forensics. He is considering launching a school or academy in thanatology (the medical and legal study of death

Power of Internet To Build Case Volume

ONE BUSINESS LESSON to be learned from 1-800-AUTOPSY is the power of the Internet to attract customers for a pathology-based business.

1-800-AUTOPSY President Vidal Herrera admits that his business does not maintain an aggressive marketing program. Further, its services are limited primarily to Southern California. Despite these facts, Herrera receives telephone calls daily with inquiries and requests for autopsies from people throughout the United States.

For the most part, it is 1-800-AUTOPSY's Web site which educates people about its services and provides contact information. The Web address is : www.1800autopsy.com.

and the conditions affecting dead bodies). This year he helped three people enter the field of forensics.

From the perspective of THE DARK REPORT, Herrera's success with 1-800-AUTOPSY provides at least four important insights. First, the 14-year life of the company and its steady growth demonstrates the substantial and unfilled demand for private pay autopsies.

Second, his business was built up through word of mouth, without the professional sales and marketing campaigns typically used to develop new business and fuel revenue growth. This is evidence that the autopsy market has substantial unfilled demand and virtually no viable competition.

Third, the large and ongoing volume of autopsy requests received by 1-800-AUTOPSY that originate from outside its Southern California service area provides compelling evidence of a sizeable market with unmet needs. The fact that families, physicians, and

attorneys from throughout the United States seeking autopsy services can find 1-800-AUTOPSY on their own and call it with a request is remarkable. It is a potent validation of a market opportunity that the pathology profession continues to overlook.

The fourth insight involves the reluctance of pathologists to take a leadership role in businesses based on pathology services and laboratory medicine. 1-800-AUTOPSY was founded by a non-pathologist. In its 14-year life, no pathologists played a critical role in financing the business, providing guidance at the board of director level, or served on its executive team.

Notwithstanding the personalities of the principals of this business, certainly the professional skills of board-certified pathologists could have advanced this business model in many useful ways. Alternatively, in observing the growth of this business, no pathologist in Southern California decided to develop a competitive business to 1-800-AUTOPSY.

This mirrors the similar absence of pathologists at the highest levels of the remaining large laboratory companies. For many reasons, the business spirit and initiative that marked the pathology profession during the 1970s and 1980s has become nearly extinct.

Entrepreneurs in Pathology

Unlike those decades, when individual pathologists and groups were willing to invest time and capital to launch businesses that expanded clinical laboratory services in their community, in this decade, little entrepreneurship within the profession has been forthcoming.

Thus, full credit should be given to Vidal Herrera for recognizing the opportunities in forensic pathology. His success with 1-800-AUTOPSY should inspire more pathologists to pursue the entrepreneurial path. **TDR**

Contact Vidal Herrera at 818-957-2178.

Prepared by: Kip Carpenter.

West Hills Lab Outreach Still Thrives in California

Community hospital laboratory holds its own in nation's toughest managed care market

CEO SUMMARY: Now in its seventh year, the lab outreach program at West Hills Hospital and Medical Center in Southern California continues to produce significant revenues. The goal was to target physicians' offices in the medical campus around the hospital and provide them a local laboratory testing option. Funded on a shoestring budget, this outreach program uses extensive outsourcing to control expenses.

HOSPITAL LABORATORY MANAGERS continue to face the ongoing challenges of increasing test quality and expanding the test menu, while at the same time reducing costs and using lab assets more productively.

It is widely recognized that hospital laboratory outreach programs are one effective way to meet these challenges. Yet the number of hospital laboratories that compete in the outreach market is relatively limited. This is particularly true in California, where reimbursement paid by HMOs for laboratory testing services is probably the lowest in the nation.

Outreach Success Story

Yet **West Hills Hospital and Medical Center (WHHMC)**, located in the San Fernando Valley community of West Hills, California, provides compelling evidence that even smaller hospitals can generate substantial benefits from a modest laboratory outreach program. It is a 236-bed hospital, owned by **HCA, Inc.**, a for-profit healthcare corporation.

In 1999, THE DARK REPORT profiled this unique lab outreach program and featured Laboratory Director Joseph McCauley at the *Executive War College* that spring. (See *TDR*, August 9, 1999.) His presentation was among the highest-rated that year because his outreach program was achieving significant success on a shoestring budget.

In the first 24 months of its operation, the West Hills Hospital and Medical Center laboratory outreach program had reached 7,000 billable tests per month and annualized net revenues had climbed to \$400,000. To minimize capital investment, WHHMC outsourced the functions of courier services, client services, billing, and collections to **United WestLabs, Inc.** This relationship continues today.

"Our outreach program is going strong," stated McCauley. "One important reason for our continued success is the physicians we serve. In our region, many doctors want a laboratory that can offer better service than the big reference labs. We compete on quality and

physicians in our community tell us we do a better job. For example, because we test up to 300 specimens per day, in contrast to the thousands at a national lab, we can turnaround results faster. For the most part, results from all the tests performed in our hospital lab are reported to client physicians the next day after the specimen was collected.

Compete On Service

“There’s another service difference. In our laboratory, quality, customer service needs, and questions from clients are answered at all levels within our labs. Physicians like the fact that they have direct and speedy access to the med techs, pathologists, and service reps who personally handle the specimens, the testing, and the reporting,” observed McCauley. “This is one competitive advantage our hospital lab has over the bigger laboratory companies.”

In the four years since 1999, outreach revenues have stabilized. “Because of how we define our service area, we knew the growth of the outreach program would plateau at some point,” said McCauley. “Currently, our outreach program is doing about 20,000 tests per month. Annual operating profit exceeds \$1 million and our average cost-per-test remains under \$3.00.”

More In-House Lab Testing

Additional specimen volume from its outreach program allows West Hills Hospital and Medical Center to set up and perform more tests in-house, including hepatitis testing. Not only does this reduce send-out volume, but it provides faster turnaround time (TAT) for both inpatient testing and outreach specimens. “We only refer about 4% of our test volume,” noted McCauley. “We’d like to whittle that number lower.”

Hospital laboratory directors and pathologists should pay close attention to another surprising attribute of the

WHHMC lab outreach program. Not only are physician-clients fiercely loyal to their hospital laboratory, but they are willing to split specimens to sustain the business relationship.

“Hospital lab directors and pathologists considering their own outreach program should recognize that physicians show lots of loyalty to their hospital’s lab outreach program,” declared McCauley. “Obviously we cannot bid for most managed care contracts. Nor would we want to, given the low reimbursement that we would have to accept. So we have a simple business strategy.

No Managed Care Contracts

“When asked about managed care contracts, we simply state that we don’t bid for these contracts, but we are willing to provide top service for those specimens the physician is willing to refer to our laboratory. Few physicians in our community take issue with this approach. Our client physicians load HMO specimens into one of the national laboratory boxes and put their PPO and fee-for-service specimens into the WHHMC laboratory box,” explained McCauley.

Laboratory directors and pathologists should not overlook the significance of this situation. WHHMC has built a viable lab outreach business without managed care contracts. Its client physicians are willing to split specimens, sending HMO specimens to the larger lab competitors and sending PPO and fee-for-service specimens to WHHMC.

This means WHHMC is testing specimens that have reasonable reimbursement, while its lab competitors are getting only the capitated and highly-discounted specimens. THE DARK REPORT observes that this denies lab competitors the “pull through” testing they need to offset the unreimbursed costs involved in

West Hills' Modest Lab Outreach Program Posts Strong Growth Over Four Years

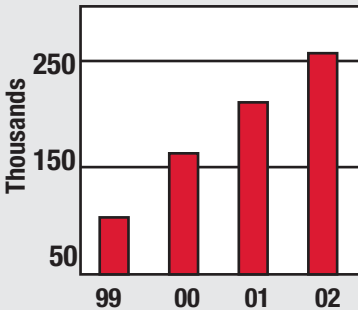
Specimen Volume, Revenue Show Sustained Increases

It is generally acknowledged that managed care has turned California into the nation's toughest market for laboratory testing services.

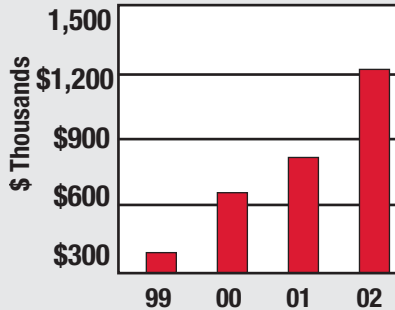
Yet West Hills Hospital and Medical Center (WHHMC) of West Hills, California has built a thriving laboratory outreach program without holding a single managed care contract. As the graphs below illustrate, during the past four years, WHHMC's outreach program has posted impressive rates of growth.

Outreach test volume for 2002 was 255,703. That's an increase of 148% from 1999's volume of 102,862. Annual net revenues topped \$1.2 million in 2002, an increase of 314% from 1999's \$381,000. One impressive measure is the improved margins. West Hills Hospital and Medical Center has increased its operating percent from 49% in 1999 to 63% in 2002. This means each test is contributing more revenue to operational expenses in the laboratory.

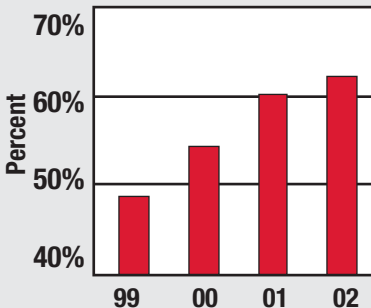
Outreach Test Volume



Annual Net Revenues



Operating Percent



West Hills Hospital and Medical Center's success in laboratory outreach testing demonstrates that even small hospitals, in tough managed care markets, can carve out a profitable share of the market. Both physician-clients and the hospital itself benefit from enriched testing services and improved clinical integration.

testing specimens covered under the HMO contract. That makes it more difficult for bigger lab competitors to justify patient service centers and other lab infrastructure around the WHHMC medical campus.

Physicians get an additional benefit from using the WHHMC lab outreach program that they cannot get from other lab competitors. "Our LIS has been configured to allow physicians to access both the inpatient and outreach laboratory test results for their patients," he said. "Our Web connectivity allows them to access these lab test results from their office, their home computer, and even their Palm Pilots and other PDAs."

Advice To Hospital Labs

McCauley is enthusiastic about the benefits of a laboratory outreach program, particularly for smaller hospitals. "Every hospital laboratory should seriously consider this business opportunity," he noted. "Just start on a small scale. We did it slowly and carefully and didn't create the pressure to achieve certain numbers by certain dates. We learned by doing."

"We were also willing to get help in areas that were not our expertise," added McCauley. "We used outsourcing to accomplish that. We enlisted experts to help us get started the right way. They had the experience in such sophisticated commercial laboratory testing business skills as client service, billing, and collections."

Outsourcing That Works

"The outsourcing arrangement has worked great for us," McCauley said. "We skipped all the weakness stage and went forward with the strength of their expertise. There is alignment of goals because United WestLabs, our outsourcing vendor, wants us to succeed and sustain the business relationship into future years."

The outsourcing contract is renewed every few years. "The money we pay is not tied to the financial performance of WHHMC, but rather a fixed dollar amount per month," explained McCauley. "During our start-up phase, monthly fees were in the range of \$15,000. They have risen only slightly during the past seven years, despite the increase in our specimen volume."

Four Lab Outreach Goals

At the inception of the lab outreach program in 1997, McCauley had four goals: 1) to fully utilize staffing on second and third shifts; 2) to fully utilize equipment during every 24-hour cycle; 3) to perform tests every day instead of several times per week; and, 4) to generate additional revenue for the hospital.

"We've achieved each of these four goals," he said. "As planned, we get more productivity out of our laboratory assets. Despite the substantial increase in test volume, we've only added four med tech FTEs during the past seven years. The additional volume has also allowed us to acquire automated instruments that further improve our productivity."

Hospital Outreach Success

For hospitals of all sizes, a laboratory outreach testing program can generate considerable benefits, both financially and strategically. The story at West Hills Hospital and Medical Center is compelling because: 1) even as a small hospital in the nation's most difficult managed care market, it has enjoyed a profitable outreach business; 2) it shrewdly used outsourcing to bring in the expertise it needed to offer competitive services to the physicians' office market; and 3) it gives physicians extra value, such as access to both inpatient and outreach laboratory test data.

TDR

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Brazil's Lab Industry Gathers in Rio de Janeiro

“Congresso Brasileiro de Patologica Clinica” attracts upwards of 6,000 participants

CEO SUMMARY: *Healthcare in Brazil remains a free market and thousands of clinical laboratories exist to fill the demand. However, there are early indications that commercial laboratories in Brazil may be on the verge of the same tidal wave of lab acquisitions and consolidation that was experienced in the United States during the past 15 years. The annual lab Congress provides a unique window on this lab marketplace.*

IN BRAZIL'S HEALTHCARE SYSTEM, the consumer remains “King” and commercial laboratories compete intensely for lab testing business.

Because there is no government healthcare system in Brazil, individuals are responsible for their healthcare expenses. Many employers provide health insurance. Competition among providers, including laboratories, is fierce. The globalization of laboratory testing services can be seen in Brazil, with its connections to North America, Europe, and Asia.

In recent weeks, THE DARK REPORT had the opportunity to travel to Brazil and attend the 37th “Congresso Brasileiro de Patologica Clinica.” Held in Rio de Janeiro on September 24-27, it attracted upwards of 6,000 pathologists, laboratory scientists, and the Brazilian equivalent of medical technologists.

Laboratory services are highly-developed in Brazil's best laboratory companies. Lab facilities operated by these companies would compare favorably with any in North America.

The experience of Brazilian laboratories is not only interesting, but offers many insights useful to pathologists and laboratory directors in the United States. First, the free-market nature of the healthcare system allows us to study how modern lab services might evolve if the consumer retains considerable freedom of choice.

Different Opportunities

Two, the different regulatory environment in Brazil allows laboratories to utilize diagnostic technology still unapproved in the United States (but approved for use in Europe, for example). Three, again, different regulations make it possible for pathologists and clinicians to interact in ways—and across regional boundaries—that might be restricted by state licensure and scope of practice laws in the United States.

One relevant difference is how the market in Brazil has stratified along economic lines. For example, there are laboratories organized specifically to serve the upper income segment of Brazil's population. To make it easy for patients

to visit patient service centers (PSCs), these labs have created “diagnostic centers” that include not only laboratory testing, but the full range of diagnostic services involving radiology, ultrasound, endoscopy, coloscopy, and the like.

This works in Brazil because physicians do not draw blood in their offices. All patients who need laboratory testing must go to the laboratory’s collection site to provide a specimen. To make this process convenient, top-end laboratories have built the multi-diagnostic centers referenced above.

The marketing idea is that, for a patient who must undergo multiple types of diagnostic procedures, offering these procedures at one site will encourage the patient to select that laboratory over one which only collects blood in its PSCs.

The fact that physicians do not draw blood in their offices affects lab services in another way. Because commercial laboratories do not need to send couriers around to physicians’ offices to pick up specimens at the end of the day, all collections are done in a limited number of PSCs around the city. Laboratories pick up specimens at these centers approximately every two to three hours and return them to the core laboratory.

Day-Shift Testing

Core laboratories are organized to perform testing on a flow basis. They test the specimens as they are received from the PSCs. These specimens have been prepped and accessioned at the service center, so they are immediately put on the line in the core laboratory.

Typically a physician gets his lab results for most tests about four or five hours after the patient collection was completed. With most testing completed on the day shift, Brazilian labs do not have to operate the high-volume batch testing done in the evenings and nights at labs in the United States.

Hospital laboratories in Brazil are organized in two different ways. First, there are general, acute care hospitals. In these hospitals, laboratory services are organized much the same as in acute care hospitals in North America. Second, the free-market aspects of Brazil’s healthcare system have led physicians to build specialty hospitals.

Many aspects of the commercial laboratory market in Brazil today resemble that of the United States in the late 1980s.

Most of these specialty hospitals are of modest size and are organized to provide dedicated services in areas such as cardiology and orthopedics. Laboratories in these hospitals offer a limited test menu. In some cases, specialty hospitals have outsourced ownership or management of the laboratory to a commercial laboratory company.

During this trip, THE DARK REPORT visited several laboratories in Sao Paulo and Rio de Janeiro. Many aspects of the commercial laboratory market in Brazil today resemble that of the United States in the late 1980s. During the past four years, three laboratory companies have used acquisitions to build themselves into a large size, relative to most laboratory companies in the country.

One striking conclusion developed during this trip to laboratories in Brazil is simple: no matter how different the health system and the local culture, the strategic management issues for laboratory administrators and pathologists are uncannily similar. Doing more with less money is a common theme in any healthcare system.

TDR

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Health Industry Trends

Healthcare Premiums Climb At Double-Digit Rate for 2004

Fourth consecutive year of big cost increases cause employers to significantly alter benefits

EXPECTATIONS that health insurance premiums will increase by an average of 12% to 15% for 2004 have captured plenty of media attention recently.

Employers and health insurers are currently negotiating premiums for 2004. There is consensus among healthcare experts that 2004 will be the fourth consecutive year of double-digit increases in healthcare costs.

For the laboratory industry, the big story is not the simple fact that healthcare costs will increase by double-digits again. Rather, the main impact of these upward-spiraling healthcare costs will be fundamental changes in the health benefits offered by employers to their employees and dependents.

More Out-Of-Pocket Costs

The common denominator in this trend is that employees will be paying more money out-of-pocket to support and supplement the health benefits package they receive from their employer. After analyzing early examples of such benefit reforms by large employers, one conclusion is that more consumers may be required to bear a larger portion of laboratory test costs in coming years.

If this occurs, it will mean that consumers will have both an economic and a quality incentive to make their own choices about which laboratory they want to do tests for themselves and

their family members. One good example of this trend is the requirement that employees pay a deductible or co-payment for hospital care. This feature was uncommon just a few years ago. For 2004, a recent study by **Kaiser Family Foundation** determined that four out of ten health plans now require a deductible or co-payment for hospital care. The same is true for prescription drugs.

For 2004, the study found that 65% of employers increased the amount that their employees pay for insurance, while 47% raised employees' required payments for prescription drugs. Deductibles and physician office co-payments were increased by 34% and 34% of employers, respectively.

One of the more profound trends involves how employers are targeting spouse and dependent coverage. Some corporations have determined that the bulk of healthcare expenses often come, not from care provided to their employees, but from their spouses and children.

To better manage expenses, companies are taking three approaches to the spouse/dependent situation. One approach is to charge the employee more to include healthcare coverage of the spouse and dependents on the primary health policy. **Boeing Corporation** is one company which implemented this policy.

A second approach is to charge additional monthly premiums if an employee's spouse declines to take the healthcare coverage offered by their own employers. The third approach is to use tiered-pricing to reflect the additional healthcare costs incurred by large families versus smaller ones. **GE Corp.** instituted tiered pricing recently.

Employees Will Pay More

Collectively, employers are utilizing these and other strategies to shift more of the cost of healthcare onto the employee so as to minimize the year-to-year increase in the cost of healthcare benefits. In tandem with these changes is a trend to increase flexible spending accounts provided to employees.

THE DARK REPORT believes that one consequence of these ongoing changes in healthcare benefits packages will be to increase the incentive of consumers to make their own decisions about which laboratory should perform tests for themselves and their family. There are two reasons for this to happen.

Healthcare-Savvy Consumers

First, consumers are already becoming healthcare-savvy. They are taking a more active role in their healthcare. Consumers educate themselves extensively about their specific health condition, or those of their elderly parents or children. Consumers are seeking out physicians which have a better reputation for quality care, sometimes traveling thousands of miles to consult with nationally-recognized doctors.

Add an economic motive to this scenario. As employers require larger amounts of money to be spent to meet deductible requirements, co-payments, and out-of-pocket costs, consumers will become economic buyers. They will want to spend this money in a cost-effective fashion and they will want to know they are getting a high quality for their healthcare dollar.

Evidence of this phenomenon can already be seen. Certain companies, such as **BellSouth Corp.** and **Perot systems**, are giving their employees a debit card that allows them to take money directly out of their flexible benefits medical account. The goal of the debit card is to make it easy for the employee to spend the money on medical services. That's because one problem with flexible spending accounts is that a low proportion of employees chose to enroll in that option, since they must often pay healthcare expenses with their own money, then wait for reimbursement from the company.

For employers, there are tax advantages in providing employees with debit cards linked to flexible spending accounts. Currently only 400,000 people in the United States use such cards. But a favorable ruling by the IRS earlier this year is sparking renewed interests. Estimates are that, by April, 1.5 million people will have these debit cards.

Taken collectively, the impact of four consecutive years of double-digit increases in healthcare costs seems to be a cost-shift from employers to employees. These changes will motivate consumers to select providers and pay for healthcare services with more care and diligence than in either the fee-for-service world of the 1980s or the gatekeeper-model HMO of the 1990s.

Opportunity For Labs

This trend will favor clinical laboratories and pathology group practices which begin to include patients (consumers) in their strategic thinking. By offering laboratory testing services that meet the needs of consumers, as well as physicians, forward-thinking laboratories should gain competitive advantage. As these trends unfold in the marketplace, it will restore power to laboratories that was co-opted by managed care companies during the past decade.

INTELLIGENCE

LATE & LATENT
Items too late to print,
too early to report



There was cautious optimism among lab industry leaders lobbying Congress to stop the proposed 20% co-payment for Part B laboratory testing services. It seems that, over the summer break, Iowa Senator Charles Grassley got a lesson in grass roots lobbying. At a number of town meetings, irate seniors showed up and asked pointed questions to the Senator about the need to institute the 20% co-pay. Grassley is considered the prime mover behind this proposal and now indicates he's considering alternatives.

MORE ON: 20% Co-pay

It appears that the efforts of independent laboratories in Iowa to educate seniors about the 20% lab test co-pay did prove effective. The **American Association of Bio-Analysts (AABA)** had encouraged its members to post flyers about the 20% lab test co-pay in their patient service centers. Some seniors learned about the 20% co-pay when they saw these posters and specifically attended town meetings in that state to confront Senator Grassley about the issue. This is one lobbying method that the lab industry should use more often.

GENETIC TESTS MAY I.D. HEALTH WORKERS' RISK TO DISEASES

One consequence of the SARS outbreak in Asia last winter is the tantalizing possibility that it may be feasible to use genetic tests to identify people most at risk if infected by SARS, including health-care workers. The study was done at **Mackay Memorial Hospital** in Taipei, Taiwan. Researchers in the hospital's transplant department had accumulated years of data on genes that produce human leukocyte antigens (HLA), proteins involved in the human immune system. During the SARs epidemic last March, researchers collected blood samples from 37 local SARS patients and three "control groups" comprising 319 non-infected individuals. Five of the six most severely-infected patients had the gene HLA-B46. All these patients required treatment on the mechanical ventilator and all but one died.

ADD TO: Genetic Test

Researchers considered this finding statistically significant, because the gene is found in no more than 15% of Taiwan's population. The study further revealed that the

gene was present in 12 of the SARS patients, or twice the rate of non-infected people in the control group. Further studies are needed before firm conclusions can be made. But the researchers noted that one value for such a genetic test would be to screen healthcare workers during a SARs epidemic. Those with a genetic predisposition to have a severe reaction to the disease could then be assigned work away from SARs wards.

SEEN IN BRAZIL

While THE DARK REPORT was in Brazil recently for the 37th "Congresso Brasileiro de Patologica Clinica," held in Rio de Janeiro, a number of pathologists and lab directors from the United States were in the country giving presentations and consulting with laboratories. Among those Americans found south of the equator during this time were: Kenneth McClatchey, M.D., of **Loyola University Medical Center** in Chicago, James H. Nichols, Ph.D., of **Bay State Medical Center** in Springfield, Massachusetts, and Erlo Roth, M.D., **Hinsdale Pathology Associates** in Hinsdale, Chicago.

*That's all the insider intelligence for this report.
Look for the next briefing on Monday, October 20, 2003*

PREVIEW #4

PATHOLOGY INCOME & EQUITY

October 24-25, 2003 • Hyatt Regency Hotel • Atlanta

Topic—Recruiting Surprises: What It Takes To Attract Top Pathologists Into Your Group:

This session explodes popular myths about the job market for pathologists. Learn why the demand outstrips the supply—for those pathologists with the right skills. Discover the types of financial packages and terms that attract today's top talent. Learn the mix of compensation, equity, and work load arrangements that attract the best candidates—at affordable terms. A "can't miss session" for any pathologist in the job market.

***For information or to register, call 800.560.6363
or visit darkreport.com***

UPCOMING...

- ***Experts Look At Lab Industry Trends: Disruptive Change or Steady Evolution? The Surprising Answer!***
- ***Critical New Legal Issues That Every Clinical Laboratory Should Address.***
- ***Lessons From Brazil's Free-Market Healthcare System: How Consumers and Physicians Chose Laboratories.***

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