

*From the Desk of R. Lewis Dark...*

# THE DARK REPORT

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

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**R. Lewis Dark**

**Founder & Publisher**



## *Management Execution Makes a Difference*

THERE'S PLENTY OF HOORAO AND EXCITEMENT about skyrocketing stock prices for several public lab and pathology companies in 2000! But this crusty old curmudgeon has been around the investment industry too long to accept Wall Street's new-found enthusiasm for clinical laboratories as definitive proof of the lab industry's financial turnaround.

For example, it's exciting to see the stock of **Quest Diagnostics Incorporated** blast through the roof, jumping from \$23 in October 1999 to as high as \$141 on September 5, 2000. But do soaring stock prices of labs represent a true shift in the fundamental financial picture for clinical laboratories? I think not. Let me explain.

Within the clinical laboratory segment, reimbursement continues to be parsimonious. Utilization of some lab tests by physicians is coming under tighter scrutiny. Technology to enable point-of-care and near-patient testing steadily approaches a point where the quality of test results and the economics of the instruments make it feasible, even desirable, to decentralize such tests from the core laboratory. So, from these perspectives, a multi-year, fast-growth profit curve from performing routine lab tests is not likely.

Within the anatomic pathology (AP) segment, I believe the sustained financial successes of **DIANON Systems, Inc.** and **IMPATh, Inc.** cannot be attributed to the fundamentally different market for AP services. Rather, I think the success of these companies is primarily dependent on their willingness to adopt corporate management techniques from non-healthcare industries and apply them to anatomic pathology. For example, unlike most pathology group practices, DIANON and IMPATH fund a well-managed sales and marketing program that generates big increases in specimens and revenues year after year.

Similarly, I believe much of the recent operating profit gains at the two blood brothers resulted from improvements in their management systems and management execution. That's why I consider it premature for Wall Street to characterize the entire clinical lab industry and the pathology profession as "hot profit opportunities." The healthcare system which supports these businesses is still undergoing radical change. Profit gains in certain lab and pathology firms are more likely attributable to their shift away from "cottage industry" management styles in favor of Fortune 100 corporate management methods.

# Specialty Labs Prepares For Public Stock Offering

*National reference lab hopes to raise up to \$86.3 million by selling its stock*

**CEO SUMMARY:** *Stock prices for public lab companies zoomed upwards through 2000. For this reason, executives at Specialty Laboratories, Inc. believe it is an auspicious time for their laboratory to bring an initial public offering (IPO) to market. Company officials recently filed a stock registration document with the SEC which provides new insights about the internal workings of this fast-growing laboratory.*

**S**OON THERE WILL BE ANOTHER publicly-traded laboratory company. On September 12, 2000, **Specialty Laboratories, Inc.** filed to raise as much as \$86.3 million through an initial public offering (IPO) of its common stock.

If successful, Specialty Labs will not only become the first clinical testing laboratory company to go public since **UroCor, Inc.**'s IPO of 1995, but it will open the door for other private lab companies to do their own IPOs. (See pages 6-7).

Based in Santa Monica, California, Specialty Laboratories has high name recognition within the laboratory industry. It's a leading source of esoteric and reference testing to hospitals and other commercial laboratories

throughout the United States. In filing its S-1 registration papers with the **Securities and Exchange Commission (SEC)**, Specialty Labs provides new details about its management strategies and business operations. It also opens a new window on undisclosed aspects of the market for esoteric and reference testing.

Of all the clinical lab testing segments, probably the least is known about the market niche for esoteric and reference testing. The reason is simple. This market is served by: 1) private lab companies which do not disclose their financial and operational performance; and 2) divisions of public lab companies, where the esoteric/reference testing business operations are not disclosed in much detail.

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Examples of the first category are companies such as Specialty Labs, Mayo Medical Laboratories, ARUP Laboratories, and American Medical Laboratories. Examples of the second category are Quest Diagnostics Incorporated (including Nichols Institute) and Laboratory Corporation of America.

### **Founded In 1975**

Originally incorporated in 1975 as Clinical Immunologies, Inc., Specialty Labs took its current name in 1985. It is a company which closely reflects the vision of its founder, CEO and Chairman of the Board, James B. Peter, M.D., Ph.D.

Most laboratorians know that Specialty Laboratories created a unique business niche in the lab industry. It originally offered high-quality esoteric and reference assays with an added twist. Unlike most existing sources of esoteric testing at the time, Specialty ran these esoteric tests several times per week.

When esoteric tests were referred to Specialty Labs, it offered faster turnaround times. Since information is the added-value of the lab world, Specialty, as the new kid on the block, gained a competitive sales edge.

This business strategy paid off. By the mid-1990s, virtually every laboratory of any size was referring at least some esoteric or reference specimens to Specialty Labs. This included the three blood brothers. Specialty had a secure national reputation at that time.

### **Story Gets Interesting**

But here is where the story gets interesting. In 1996, Specialty Labs expanded its sales force and offered to become a primary provider of reference and esoteric testing to hospital laboratories. By the end of 1996, Specialty was the primary send-out lab provider for 67 hospitals.

Buoyed by this success, Specialty Labs decided it would become a full-blown competitor to the existing national reference labs, including ARUP, Mayo, Corning Clinical Labs (now Quest/Nichols), Smith-Kline Beecham Clinical Laboratories (SBCL), and LabCorp.

Hospital lab sendouts became a full-scale sales and marketing effort at the growing company. In 1997, Specialty had 33 sales people. Hospital customers generated 32.5% of its revenues. By June 2000, Specialty had 60 sales people in the field. In public filings, Specialty claims it has 2,100 hospital clients, of which it is the primary provider of esoteric testing for 300 hospitals. Hospital revenues now account for over 50% of Specialty's net revenues.

### **Strong Revenue Growth**

During the past few years, Specialty has enjoyed strong revenue growth. From a revenue base of \$39 million in 1995, Specialty is on track to exceed \$148 million in revenues for 2000.

For clients and readers of THE DARK REPORT, Specialty Labs' public filings provide a fascinating peek into the management strategies of a lab familiar to many, but understood by few.

First, Specialty believes that its expertise in diagnostic assay research and development differentiates it from its lab competitors.

Second, Specialty is investing heavily in laboratory information products and services. It sees an added-value advantage in being first to market with sophisticated lab information capabilities.

Third, Specialty is automating its laboratory testing processes to reduce costs while improving productivity and accuracy.

Fourth, Specialty Labs is emphasizing a well-funded and aggressively managed sales and marketing program.

# Revealing Peek Into Specialty Labs

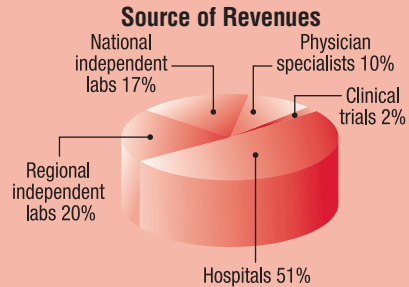
## At-A-Glance

- **Core lab in Santa Monica, California (85,357 sq. ft. in three buildings)**
- **Offers 3,500 esoteric assays**
- **Offers 300 routine reference assays**
- **Molecular diagnostic assays currently 41% of net revenues**
- **“Branded” assays currently generate 43% of net revenues**
- **774 Employees, including**
  - 36 M.D.s or Ph.D.s
  - 36 R&D staff
  - 74 Sales & marketing staff
  - 56 Information technology staff
- **Passive investment partner in lab companies in India & Singapore**
- **Contract provider for: AmeriNet, Joint Purchasing Corporation, Managed Healthcare Associates,**  
*Source of data: public filings by Specialty Laboratories, Inc.*

IN ITS PUBLIC FILINGS, Specialty Laboratories provides a unique look into the details of the esoteric and reference testing marketplace. As the chart below demonstrates, since 1997, Specialty Labs has posted steady growth in net revenues.

Annual Net Revenues		
1995	\$ 39.0 million	
1996	\$ 55.7 million	16.7% increase
1997*	\$106.3 million	90.8% increase
1998	\$113.8 million	7.6% increase
1999	\$130.1 million	14.3% increase
2000 est.	\$148.00 million	13.7% increase

## SPECIALTY LABS' CUSTOMER MIX



The strategy of being first with cutting-edge diagnostic assays is the linchpin supporting Specialty Labs' other business strategies. The company is feeding a steady stream of new esoteric assays into the marketplace. During the past five years, its R&D group has developed about 600 new diagnostic assays.

## Branded Esoteric Assays

More importantly, for the first six months of 2000, about 43% of Specialty Labs' revenues came from its *branded* esoteric assays! This means that, unlike other national reference labs, Specialty Laboratories is creating a substantial added-value business based on its particular “brand” of esoteric assay.

These branded esoteric assays also support Specialty Labs' second business strategy—offering customers enhanced lab information services. Among national reference labs, Specialty has been in the forefront of offering ASP-based, Internet-enabled lab information products. (*See TDR, December 13, 1999*).

Its DataPassportMD™ product is now used by 1,200 of its customers. Specialty's success in efforts to electronically connect with its clients is demonstrated by an interesting fact: 85% of the transactions between Specialty Labs and its customers are electronic; 50% of the transactions are Internet-based.

This “automation” of a traditionally paper-based system for ordering and

reporting tests also supports Specialty Labs' third strategy: automation of pre-analytical, analytical, and post-analytical work flow processes.

In this regard, Specialty Labs has a unique problem. It must handle specimens involving 3,500 different esoteric assays and another 300 common routine reference assays.

### **Self-Engineered Solutions**

To automate specific lab testing work processes, Specialty is self-engineering its own automation solutions. It's using automation software and equipment developed for manufacturing and industrial applications.

The first automation project went live this summer. Specialty calls it "Total Accessioning Re-organization system" (TARO™). It automates certain aspects of pre-analytical and post-analytical specimen management. Next in the works is an automated solution for high-throughput, precise aliquotting. It is expected to become operational in 2001.

It takes a productive sales program to feed the increased volume of specimens needed to support these other strategies. Most hospital lab administrators will acknowledge that Specialty Labs has a well-organized sales force constantly calling on hospitals throughout the United States.

### **Professional Sales Force**

It is this sales force which is feeding the sustained growth in specimen volume and revenues at Specialty Labs over the past five years. Specialty's experience is additional proof that professional sales and marketing in the lab industry can deliver profitable results.

Specialty Laboratories is about to initiate another strategic management program that can have positive impact on its operations and customer service levels. Beginning in 2001, Specialty Labs intends to pursue ISO-9000 certification.

When Specialty accomplishes this goal, it will join Quest Diagnostics as the only other laboratory company in the United States to have ISO-9000 certification.

It should be expected that, if Specialty Laboratories successfully completes its IPO, the resulting war chest of \$86.3 million will make Specialty Laboratories an even tougher competitor in the esoteric and reference testing marketplace.

With the filing of its stock registration, Specialty Laboratories now enters a quiet period. SEC "gun-jumping" rules preclude company officials from making statements which would be construed as promoting the company during the time prior to a public equity offering. Until the IPO is completed, company officials will decline to comment in lab industry publications and at meetings.

### **"News Blackout" In Force**

However, despite this "news blackout," the company's public filings have already provided interesting insights into the competitive battles going on between national reference labs in the esoteric and reference testing market niche.

THE DARK REPORT believes that competition for esoteric and reference testing will be one of the most hotly-contested segments of diagnostic laboratory testing during this decade. In fact, esoteric testing figured prominently in the strategic growth plans disclosed by public lab companies presenting at **US Bancorp Piper Jaffray's** "Diagnostics Services" conference in New York last week.

With the specter of increased competition for esoteric and reference testing looming, Specialty Laboratories' IPO offering may turn out to be a shrewdly-timed strategic move. **TDR**  
*Contact Robert Michel at 503-699-0616.*



# Successful Specialty IPO Can Open Door for Others

*Several laboratory companies waiting for the right moment to offer their stock*

**CEO SUMMARY:** *It's no secret that a handful of laboratory companies would like to complete an initial public offering (IPO). If Specialty Labs' public offering goes well, expect these lab companies to bring their own stock offerings to the public equity markets. As the number of public lab companies increases, the competitive marketplace for laboratory services will undergo fundamental change.*

**A**RE SOARING STOCK PRICES for public lab companies going to trigger a stock market "gold rush" in the clinical lab industry?

If **Specialty Laboratories, Inc.** does well with its \$86.3 million initial public offering (IPO), then several other clinical laboratory and pathology companies will be encouraged to offer their own IPOs.

## More Lab-Related IPOs

THE DARK REPORT was first to predict that a wave of laboratory-related IPOs would soon occur during the next 18 months. (*See TDR, July 31, 2000.*) The obvious candidates with stated ambitions to go public are **Dynacare, Inc.** (Toronto, Ontario), **Esoterix, Inc.** (Austin, Texas), and **AML-APL, Inc.**, the laboratory company made up of **American Medical Laboratories, Inc.** (AML) in Chantilly, Virginia and **Associated Pathologists Laboratories, Inc.** (APL).

One common denominator among these companies is their primary emphasis on clinical lab testing. At

these labs, the major source of revenues is laboratory testing rather than anatomic pathology procedures.

The other category of lab companies which are likely candidates for an IPO are the pathology practice management companies (PPM). During 1997 and 1998, venture capitalists funded several pathology PPMs with the specific objective that, at some future point, the company would become public.

The most likely candidates in this group are **InformDX, Inc.** (Nashville—formed by the recent merger of **Pathology Consultants of America** and **PathSOURCE**), **USLabs, Inc.** (Irvine), and **Pathology Partners, Inc.** (Dallas).

## Premature Time For An IPO

For those familiar with the business activities of these pathology PPMs, it might seem premature for them to attempt an IPO. However, the impressive financial performance of **DIANON Systems, Inc.** and **IMPATh, Inc.** may be creating an IPO window of opportunity. Investor

money would support another pathology company IPO. Armed with the funds from a successful IPO, any of these pathology PPMs would have the additional capital needed to move faster in the healthcare marketplace. Each could swiftly carve out market share and build the customer base necessary to maintain a profitable business in anatomic pathology services.

### First Lab IPO Since 1995

When Specialty Labs' \$86.3 million IPO is funded, it will become the first clinical laboratory to accomplish this feat since **UroCor, Inc.** did it in 1996. Pathology-based **IMPATh** and **AmeriPath, Inc.** did their IPOs in 1996 and 1997, respectively.

Owners of the handful of sizeable independent commercial labs still operating in the United States will also benefit from increased Wall Street interest in the clinical lab industry.

In recent months, investment groups have begun to approach many of these independent labs to open acquisition discussions. Their business plan is to roll up enough individual labs to create a sizeable company which would eventually sell its stock to the public. If that business plan sounds familiar, it is. It's precisely what fueled the laboratory consolidation tidal wave of 1985-1994.

### Next Generation Of Lab IPOs

However, there is something more significant about this next generation of lab- and pathology-based IPOs. As the number of publicly-traded lab companies increases, there will be a corresponding increase in the management sophistication of the clinical laboratory industry and pathology profession.

The reason is simple. As various lab companies go public, they acquire an investor base of sophisticated business people. These investors will insist that both clinical labs and pathology

## Will Dynacare be Next To File for an IPO?

IN RECENT WEEKS, an increased number of rumors have surfaced that claim **Dynacare, Inc.** is preparing its registration statement for an initial public offering (IPO).

These rumors come from credible sources. Dynacare was not a presenter last week at the "Diagnostic Services" conference hosted by **US Bancorp Piper Jaffray** in New York City. Some observers interpreted Dynacare's absence as a sign that the company wanted a low profile while it prepared to file for its IPO.

companies operate with the same types of professional corporate management techniques used by such well-run companies as **Intel** and **Motorola**.

Public lab companies will need to demonstrate sustained growth in revenues. They will also have to continuously lower costs while simultaneously improving product quality and customer service.

The new generation of managers and administrators in the nation's hospital labs, commercial labs, and pathology group practices may have lots of technical education (M.D.s, Ph.D.s, etc.), but they will have equal competence in skills such as business administration, finance, marketing, sales, and operations.

For this reason, THE DARK REPORT believes that the next crop of lab companies which go public will have a beneficial impact on both the clinical lab industry and the pathology profession. The era of modern corporate management is about to supersede the remnants of our fading "cottage industry" situation that still lingers from the 1980s-vintage healthcare system.

**TDR**

Contact Robert Michel at 503-699-0616



# Reference Lab Rankings

*Little is known about how the marketplace for hospital send-out testing is divided among national laboratory competitors. These rankings mark the second year THE DARK REPORT has attempted to measure the market for hospital esoteric and reference testing. This ranking does not include niche or specialty laboratory companies which provide specific lines of testing to hospital laboratories. Each company had the opportunity to make corrections and provide additional input as appropriate. Further, some of these national laboratories do not track hospital send-out testing as a separate category. Thus, even self-reporting has certain inaccuracies which must be acknowledged.*

## NATIONAL ESOTERIC/REFERENCE LABS

### Hospital Send-Out Testing Ranked By 1999 Annual Revenue ((\$'s in millions)

<b>Rank</b>	<b>Laboratory</b>	<b>(in millions) 1999 Revenue</b>
1.	Quest Diagnostics Incorporated <sup>1</sup>	Teterboro, NJ \$ 400
2.	Laboratory Corporation of America <sup>2</sup>	Burlington, NC \$ 175
3.	Specialty Laboratories, Inc. <sup>3</sup>	Santa Monica, CA \$ 148
4.	American Medical Laboratories, Inc. <sup>4</sup>	Chantilly, VA \$ 129
5.	ARUP Laboratories, Inc. <sup>5</sup>	Salt Lake City, UT \$ 116
6.	Mayo Medical Laboratories, Inc. <sup>6</sup>	Rochester, MN \$ 91
7.	Esoterix, Inc. <sup>7</sup>	Austin, TX \$ 55

**Total For Seven National Reference/Esoteric Laboratories \$1,114**

Notes: 1) Provided by Quest Diagnostics based on pro-forma testing revenue.

2) Laboratory Corporation of America does not track hospital send-out testing as a separate category. It provided a number of \$105.6 million molecular testing and \$159.6 million for esoteric testing done at the Powell Center for Esoteric Testing. These numbers include testing referred directly from physicians offices, as well as hospital send-out tests. TDR estimates \$175 million of this number originates from hospitals.

3) Source is recent public filings.

4) Source is American Medical Laboratories. This number is for hospital send-out testing only and does not include its revenues from physician offices.

5) Source is ARUP Laboratories for fiscal year ending 6/30/2000.

6) Mayo Medical Laboratories declined to provide numbers. Estimate is based on corporate investment rating services and other sources.

7) Source is Esoterix and the numbers include direct physician testing services.



# Bill Bonello Sees Opportunities In Diagnostic Services Companies



*"We believe the clinical laboratory industry has attractive prospects for steady earnings growth."*

—William B. Bonello

*He explains why professional investors have increased interest in lab testing & anatomic pathology*

**CEO SUMMARY:** *With the clinical laboratory industry now enjoying growing interest by professional investors, THE DARK REPORT traveled to New York City to meet with financial analyst William B. Bonello, of U S Bancorp Piper Jaffray. Bonello co-authored a just-released overview of what he calls the "diagnostic services industry." He is bullish on the future prospects for both clinical laboratories and anatomic pathology companies. In this interview, Bonello explains why fundamentals in the lab industry are providing new opportunities for lab companies to boost revenues and earnings.*

**EDITOR:** I would like to explore three facets of the lab industry with you. They are: 1) reasons for the rapid run-up, since January, in the share prices of selected lab companies; 2) what your crystal ball predicts for the future in diagnostic testing services; and 3) your assessment of the business strategies at several public lab companies. Let's start with how you define the diagnostic services industry. Last week U S Bancorp Piper Jaffray released a report co-authored by you and Angela C. Samfilippo on this industry segment.

**MR. BONELLO:** I use the term "diagnostic services" to cover my assessment of companies that offer diagnostic testing services as providers.

**EDITOR:** So that excludes, for example, companies such as in vitro diagnostic (IVD) manufacturers?

**MR. BONELLO:** Yes. I focus on provider companies in diagnostic ser-

vices because they share two elements. First, clinical advances have a direct impact on their business. Second, activities of both private payers and government health programs directly affect their ability to earn profits.

**EDITOR:** Let's get right into it, then. Why do think the stock prices of companies like **Quest Diagnostics Incorporated, Laboratory Corporation of America, DIANON Systems, and IMPATH** increased substantially during the last 10 months?

**MR. BONELLO:** Three factors support higher share prices for these companies. The starting point is factor number one: these companies outperformed the expectations and predictions of financial analysts.

**EDITOR:** So their operating profits and earnings were measurably greater than predicted by Wall Street?

**MR. BONELLO:** Precisely. Stock is priced relative to the forecasted earnings of a company. If earnings are greater than expected, the stock price will go up.

**EDITOR:** So these companies are showing unexpectedly large increases in their profit flows.

**MR. BONELLO:** That's correct. The reported earnings were higher than what either investors or analysts had projected. The second factor involves the perception by investors that buying these companies' shares is a relatively low-risk way to play in the genomics and molecular diagnostic markets.

**EDITOR:** That's interesting. Please explain.

**MR. BONELLO:** As you know, the human genome project is only the spearpoint for revolutionary changes in medicine, particularly in diagnostics and therapeutics. Investors believe that holding shares of a laboratory company is one way to bet on this entire "class" of technology. That's because laboratories will sell the diagnostic tests produced by any IVD manufacturer.

**EDITOR:** That means, even if investors missed investing in, say, **Roche** as its PCR testing technology emerged from the research lab, by investing in Quest Diagnostics or LabCorp, that same investor can still profit from the increasing volume of PCR testing that takes place.

**MR. BONELLO:** True. It's one way for investors to "cover their bets" in the area of diagnostics.

**EDITOR:** What's your third factor?

**MR. BONELLO:** My third factor contributing to the run-up in lab stock prices has to do with the reality of their business environment. Investors can see that growth in the specimen volume at certain of these companies is accelerating. This is occurring in tandem with increased pricing for these tests. Since laboratories have a high-cost structure, investors know that increased volume, combined with increased prices, leads to very strong growth in operating profits and earnings.

**EDITOR:** Pricing is a topic of interest to most laboratories. Please explain why you believe that Quest Diagnostics and LabCorp will experience improved pricing over the next couple of years.

**MR. BONELLO:** I think the improvement in pricing for lab tests that was reported by these two companies recently is directly due to the removal of **SmithKline Beecham Clinical Laboratories (SBCL)** from the market. This was the aggressive pricer. Now that SBCL is gone, it is easier for Quest Diagnostics and LabCorp to negotiate improved prices for managed care contracts.

**EDITOR:** Then you believe the two blood brothers are repricing their existing lab business by negotiating higher prices whenever existing contracts come up for renewal?

**MR. BONELLO:** Yes. But other favorable trends will also contribute to higher pricing for lab tests. For example, managed care companies are get-

ting higher premium increases. This gives them additional money to pass along to providers, like laboratories. Further, HMOs have customer problems. Restricting the ability of their doctors and patients to choose providers such as laboratories has proved to be unpopular with consumers. Thus, many HMOs are allowing more labs to be contract providers.

**EDITOR:** Is there less capitation for lab testing services?

**MR. BONELLO:** Definitely. Both Quest and Lab Corp report a decline in the percentage of revenue derived from capitated agreements.

**EDITOR:** That's a major development for the lab industry.

**MR. BONELLO:** I believe it's hugely significant. HMOs are moving away from capitation and this will definitely benefit clinical laboratories. When you add up the changing dynamics among managed care companies, there is a subtle shift in the balance of power which favors laboratories over payers.

**EDITOR:** Do you believe the two blood brothers will enjoy a boost in earnings directly linked to how they shift their internal mix of payers and contract types?

**MR. BONELLO:** Definitely. I also think the major lab companies are working to shift their internal mix of tests. As they add more reference and esoteric tests to their test mix, the higher reimbursement from such tests will increase operating margins and earnings.

**EDITOR:** So far, you've described three factors which you believe will continue contributing to higher earnings for the national labs. What types of trends in diagnostic testing do you predict will also improve the financial performance of clinical laboratories?

**MR. BONELLO:** When you look at the overall market for diagnostic

testing, I see a number of positive developments. For example, we believe that the absolute number of diagnostic laboratory tests will increase by anywhere from 3% to 5% during the next few years.

**EDITOR:** That's certainly a modest growth rate. How does it support strong earnings predictions for the two blood brothers?

**MR. BONELLO:** That's easy. It doesn't take huge increases in specimen volumes to generate respectable increases in lab earnings. As a business with high fixed costs, specimen volume gains that exceed the break-even point for the labs will generate proportionally higher profits.

**EDITOR:** I agree. That's a basic fundamental in laboratory economics.

**MR. BONELLO:** What will reinforce the year-to-year increases in the volume of lab tests performed are the population demographics. As increasing numbers of Americans reach their 50's, and beyond, there is a steady increase in the number of lab tests utilized in their healthcare.

**EDITOR:** Is there anything else that reinforces these "aging" trends?

**MR. BONELLO:** If anything, it will be increased involvement of consumers. Greater numbers of people are taking control of their healthcare. As I mentioned earlier, HMOs are having to improve the way they service their patient-customers. Integrated health systems and hospitals are beginning to respond to this consumer movement.

**EDITOR:** You also have some specific data on laboratory reimbursement trends.

**MR. BONELLO:** That's true. I see evidence that the overall reimbursement cycle is swinging in favor of laboratory providers. Right now, HMOs are getting premium increases of 6% to

12%. This makes it easier to pass some of this along to providers like labs. Eventually there will be an employer backlash against rapidly-rising health-care prices. This starts the cycle of price-squeezing. But, it is likely that employers may, over the next few years, require increased health benefit contributions from employees as one way to counter increased premiums.

**EDITOR:** That's an interesting way to look at the problem. It makes sense.

**MR. BONELLO:** Moreover, since this entire cycle takes a number of years, labs should see a favorable reimbursement environment in the foreseeable future.

**EDITOR:** To this point, you've shared your thoughts on the reasons behind the big run-up in the share prices of the two blood brothers. You've also discussed why you believe their financial performance will continue to support further share price gains. Could you tell us what you think are differences between the two leading lab companies--Quest Diagnostics and LabCorp?

**MR. BONELLO:** That's an interesting question! To start with, both companies have lots of similarities. In fundamental ways, they run parallel operations. So it is important to recognize that the differences which exist today do not make them radically different from each other.

**EDITOR:** So the starting point is to understand that both companies are very similar in operational structure, specimen mix, and payer relationships.

**MR. BONELLO:** That's probably a good way to characterize their similarities. What I consider, at this time, to be the main difference between the two is that Quest Diagnostics is unquestionably the market leader, due to its \$3.5 billion in revenue. But, Quest Diagnostics is also the leader in most

submarkets served by both companies. Being the market leader bears fruit in a number of ways. It makes it easier for Quest Diagnostics to negotiate favorable contracts with the largest private payers. It makes Quest Diagnostics the partner of first choice for strategic joint ventures, such as those involving drug companies and research consortiums.

**EDITOR:** Yes, go on...

**MR. BONELLO:** In contrast, LabCorp seems to be the first mover in esoteric testing. With its national infrastructure, it is moving to position itself as a major source of esoteric testing. It wants to play a significant role in bringing new diagnostic technology into the health-care marketplace. Meanwhile, Quest Diagnostics looks at its national infrastructure and seeks to leverage this asset into a major provider of laboratory information. Quest Diagnostics is also striving to convert itself into a respected "brand," known by payers, physicians, and consumers.

**EDITOR:** What you describe are two companies which are fundamentally similar, other than revenue size, but will evolve differently in the future because of these differing business strategies.

**MR. BONELLO:** Correct. I expect that the two companies will start to look different as they restructure themselves to achieve their distinctly different strategic goals.

**EDITOR:** One subject that I wanted to explore with you is anatomic pathology.

**MR. BONELLO:** I see anatomic pathology as a diagnostic service which is worth tracking. In fact, I believe molecular and genetics technology now moving through research labs may cause anatomic pathology and clinical lab testing to become increasingly interconnected.

**EDITOR:** Of the existing anatomic pathology companies, you cover **AmeriPath, Inc.** and monitor **DIANON Systems, Inc.**, **IMPATH, Inc.** and **UroCor, Inc.** Will that change?

**MR. BONELLO:** Obviously I cannot comment on whether or not we will cover other companies. We have covered AmeriPath since its IPO, which is what caused me to begin looking at the whole class of companies in diagnostic services.

**EDITOR:** Do you see the anatomic pathology (AP) companies as different from clinical laboratory companies?

**MR. BONELLO:** No. I believe the business and healthcare fundamentals influencing AP companies and clinical laboratories to be similar.

**EDITOR:** What is your assessment of AmeriPath?

**MR. BONELLO:** First, AmeriPath's stock trades at a steep discount to the rest of the companies in diagnostic services.

**EDITOR:** Does that mean, relative to its level of operating profit and earnings, AmeriPath's stock price is valued less than the stock of, for example, the two blood brothers?

**MR. BONELLO:** Yes. For investors, that is one reason to consider that AmeriPath's share price is undervalued.

**EDITOR:** What other business factors make you optimistic about AmeriPath's future?

**MR. BONELLO:** From the perspective of a stock investor, I like the fact that AmeriPath is shifting its emphasis away from growth by acquisition. Instead, it wants to grow by increasing specimen volumes and revenues of its existing pathology operations.

**EDITOR:** Do you believe this is something it can accomplish?

**MR. BONELLO:** Yes. AmeriPath has a local presence in several regional markets. In these areas, its pathologists have strong relationships with both doctors and hospitals. I think this positions them to generate additional revenues from tissue banking activities and increased case referrals from local doctors in their service area.

**EDITOR:** What would make it difficult for AmeriPath to achieve these goals?

**MR. BONELLO:** There are two basic challenges. First, AmeriPath owns and manages doctors' practices. There is a lot of recent business history that says

*"...point-of-care testing is a longer-term risk to the laboratory industry as we know it today."*

it is difficult to manage doctors. Second, because AmeriPath is the sum total of the individual pathology practices that it owns, it is more difficult for AmeriPath to generate economies of scale compared to some of the national AP companies.

**EDITOR:** You are saying that a company like DIANON Systems, with its centralized laboratory and pathology centers, may be generating cost savings that AmeriPath cannot match?

**MR. BONELLO:** Basically, yes. But on the other hand, AmeriPath is in a good position to capitalize on its local presence with such fast-evolving diagnostic services as molecular pathology and tissue banking.

**EDITOR:** Could we also talk about your views on such lab technologies as point-of-care (POC) testing and its potential to shift routine testing out of



the core laboratories operated by hospitals and commercial labs?

**MR. BONELLO:** My best answer is that POC is a longer term risk to the laboratory industry as it is organized today. At this point, it is not clear that the economic model for several POC options indicates that it is not supportable. In the near term, we may see POC technology creating a modest shift of testing within an integrated healthcare network. But there are lots of uncertainties about POC testing. During the next year or two, there may be some very effective POC technology hit the market.

**EDITOR:** What about the future of hospital laboratory outreach programs. Do you see such outreach programs making inroads against commercial labs like the two blood brothers?

**MR. BONELLO:** That's the \$20 billion question. When I attended your *Executive War College* in New Orleans last May, I gained a greater appreciation for the potential of a professionally-marketed hospital lab outreach program to capture substantial market share in their community. But I am also aware that many hospitals don't have detailed and accurate knowledge about their outreach laboratory costs. From that perspective, the jury is out as to whether a hospital lab outreach program is a strategic asset for a hospital and is, in and of itself, a profitable investment.

**EDITOR:** What do you believe will be the role for hospital labs as new diagnostic technology is cleared for clinical use?

**MR. BONELLO:** That's an interesting question. If you look at the trend for increased outpatient procedures, a shortening length of stay for inpatients, and the complexity of advanced esoteric assays, you could make an argument that lots of lab testing may shift away from the hospital. But does that

mean such tests are performed by national esoteric laboratories? Or would hospital lab specimens end up in regional esoteric testing labs, established in common by the leading hospital systems in the area?

**EDITOR:** That may be simplifying the impact of complex esoteric assays, which have yet to leave the research lab and enter the clinical market. Healthcare will remain a local business. Hospital labs and community hospital-based pathologists have tight relationships with local physicians and patients that cannot be easily replicated by national lab and AP companies.

Bill, do you believe investor interest in the laboratory industry will remain strong?

**MR. BONELLO:** Definitely. As you know, our diagnostic services industry meeting was in New York last week. Institutional investors want to learn more about lab testing as a business. I've explained my reasons about why the lab industry should see improved financial performance in the coming years.

**EDITOR:** Do you think at least some of these investors are seeking private laboratory or anatomic pathology companies for possible investment?

**MR. BONELLO:** Definitely. Investors attended this conference on diagnostic services specifically because they wanted to learn more the lab industry as well as identify likely investment prospects.

**EDITOR:** If true, there's certainly some interesting changes yet to come. Bill, thank you for sharing your analysis about diagnostic services.

**MR. BONELLO:** You're welcome. I hope THE DARK REPORT's readers find this information to be useful. **TDR**

Contact William Bonello at 612-303-5532.



# Lab Industry Briefs

## Piper Jaffray Illustrates “New” Paradigm for Role of Lab Tests

WHEN FINANCIAL ANALYST William B. Bonello issued his overview report on the diagnostic services industry last week, little did he know that one element of his report would prove an instant hit with lab industry executives.

During the U.S. Bancorp Piper Jaffray conference last Thursday, at least four companies included Bonello’s “paradigm shift” diagram (see below) as part of their presentations to institutional investors.

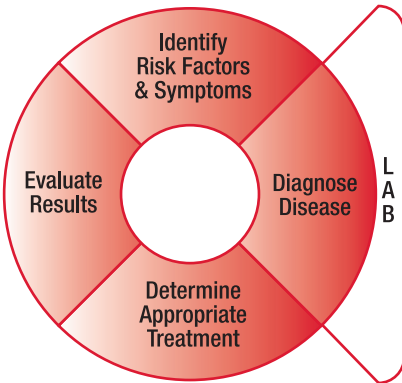
THE DARK REPORT predicts that this diagram will become quite familiar to everyone who is

active in clinical laboratory testing and anatomic pathology. The diagram illustrates how Bonello expects to see laboratory testing evolve from its primary involvement in disease diagnosis toward an essential role in virtually every aspect of early detection, diagnosis, prognosis, and patient-monitoring.

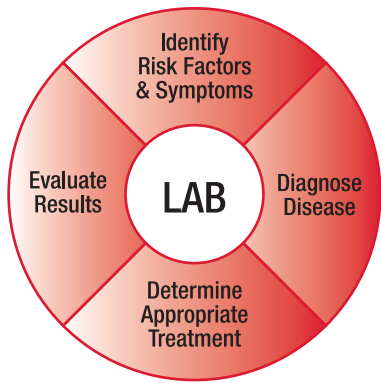
It is Bonello’s assessment that diagnostic testing will become increasingly important as the American healthcare system moves toward comprehensive integration of clinical care. (See his interview on pages 9-14.)

### Laboratory Evolution

#### OLD PARADIGM



#### NEW PARADIGM



Here’s the diagram as presented on page 16 of the Diagnostic Services Industry Overview, U S Bancorp Piper Jaffray Equity Research

# Is it Early-90s “Deja Vu” For Today’s Lab Industry?

*As the decade of the 1990s opened, it was a roaring stock market for lab companies*

**CEO SUMMARY:** *Stock prices for laboratory and pathology companies have skyrocketed since the new decade of the 2000s dawned on January 1. Is investor optimism warranted by the opportunities ahead in diagnostic testing? Or will history repeat itself if the continuing evolution of American healthcare proves as financially unhealthy to independent lab and pathology firms as it did in the 1990s?*

TO USE A FAMOUS MALAPROPISM, attributed to baseball’s beloved Yogi Berra, it may be “deja vu all over again” in the clinical laboratory industry!

Lab executives and pathologists with long memories will remember the opening years of the last decade as boom years for the clinical laboratory industry. It was similar to the rampant optimism investors now shower on public lab companies in this first year of the new decade.

As the 1990s dawned, public lab companies were posting record profits. Investors loved the performance of such stocks as **Allied Clinical Laboratories**, **Damon Laboratories**, **National Health Laboratories**, and **Nichols Institute**.

## **Strong Profit Contributions**

Laboratories which were divisions of larger corporations were making strong contributions to the revenues and earnings of their parent. These included **MetPath (Corning Corporation)**, **SmithKline Beecham Clin-**

**ical Laboratories (SmithKline PLC)**, and **Roche Biomedical Laboratories (Roche Holdings)**.

Boomtime in the laboratory industry encouraged additional lab companies to go public. **MetWest** was formed and became **Unilab**. **Universal Standard Medical Laboratories**, **Physician Clinical Laboratories**, and **Meris Laboratories** all tapped public equity markets with successful IPOS in the first years of the 1990s.

## **Flush Times in Early 1990s**

However, flush times in the early 1990s didn’t last. By the mid-1990s, declining reimbursement from Medicare and the growing impact of capitated managed care contracts combined to seriously erode the revenue base of commercial laboratories.

Throughout most of the 1990s, Medicare fraud and abuse investigations led to multi-million dollar settlements by almost every large laboratory company. HCFA’s establishment of onerous laboratory compliance programs in 1997 added further financial

burdens to the beleaguered clinical laboratory industry.

The results were remarkable. By 1999, *not one* of the laboratories listed above had survived in its original corporate form or with its original investors intact! The lab industry's go-go years of 1990-1994 collapsed into financial turmoil and widespread restructuring for the remainder of the decade.

### Handful Of Surviving Labs

As 1999 ended, the independent commercial lab industry consisted of the two blood brothers plus a comparative handful of surviving, independent regional lab companies. There was similar consolidation and contraction in the hospital lab segment. Expansion of integrated hospital networks during the last half of the 1990s meant that consolidated hospital core lab organizations were now the dominant business form for hospital lab testing.

Now we have the birth of a new decade. Circumstances seem eerily similar to 1990. In the first year of the 2000 decade, Wall Street investors are bidding up share prices of public laboratory and pathology companies. As the table in the sidebar illustrates, share price increases for the year are spectacular for this class of companies.

***The results were remarkable. By 1999, not one of the laboratories listed above had survived in its original corporate form or with its original investors intact!***

The growing interest by investors in the lab industry is precisely what motivated **Specialty Laboratories, Inc.** to announce its initial public offering (IPO). As noted elsewhere in this issue, THE DARK REPORT predicts that, if Specialty Lab's IPO is success-

## Booming Stock Prices For Lab Companies

Here's a snapshot at how the stock market favored certain laboratory companies with rapid increases the value of their common stock during 2000.

<u>Firm</u>	<u>12 Mth: High</u>	<u>Low</u>	<u>Close 9/29</u>
Quest	\$23	\$141	\$114
LabCorp <sup>1</sup>	\$22	\$132	\$119
IMPATH <sup>2</sup>	\$8	\$64	\$63
DIANON	\$9	\$47	\$40
AmeriPath	\$7	\$15	\$14
UroCor	\$3	\$9	\$8

<sup>1</sup> 1-for-10 reverse split on 5/3/00

<sup>2</sup> 2-for-1 split on 8/28/00

ful, during the next 18 months a number of other private laboratory and pathology companies will attempt their own IPOs.

If professional investors decide to shovel significant amounts of capital into the laboratory industry and pathology profession, there will be profound changes. Such money always comes with accountability for how it is used to generate revenue growth and increased earnings.

That is why the question about "birth of the decade" *deja vu* is relevant. Many aspects of the lab testing marketplace remain challenging and formidable. THE DARK REPORT believes that accomplishments of public lab companies in 1999 and 2000 have more to do with improved management execution than with an "easy" lab marketplace.

Notwithstanding that fact, it is clear that changing circumstances in the laboratory marketplace are creating new profit opportunities for those lab organizations willing to pursue them. **TDR**  
Contact Robert Michel at 503-699-0616.

# INTELLIGENCE

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



More clinical laboratories are interested in obtaining ISO-9000 certification. The laboratory divisions of **Kaiser Permanente-Southern California** and **Kaiser Permanente-Northern California** are each preparing for an ISO-9000 certification effort. As reported in this issue of THE DARK REPORT, **Specialty Laboratories, Inc.** expects to pursue ISO-9001 certification during 2001.

## ADD TO: LAB ISO-9000

Meanwhile, **Quest Diagnostics Incorporated** is moving rapidly to expand the number of its lab facilities with ISO-9000 certification. First it was Quest Nichols Institute in 1998. Since then, Quest Diagnostics labs in Juarez, Mexico; Deerfield Beach, Florida; and Wallingford, Connecticut have gained ISO-9002 certification. THE DARK REPORT visited Teterboro headquarters last week to learn more about Quest Diagnostics' ISO-9000 activities. Look for a full briefing in an upcoming issue.

## GROWING NUMBERS OF DOCS SIGN UP FOR WEB SERVICES

For skeptics who say that doctors won't embrace Internet-based services, here's some interesting information. **EPocrates.com** now says that 100,000 of the nation's 600,000 physicians have signed to use the company's PDA services. Called **qRx**, ePocrates uses a wireless Palm platform to deliver pharmaceutical information, including dosing and interactions. More significantly, ePocrates says it is signing up 400 new physician users daily! It also has 25,000 pharmacists and physician assistants currently using the service. As doctors become familiar with wireless PDAs, it will be natural for them to want to access laboratory data via wireless PDAs.

## TLA RETROSPECTIVE SCHEDULED IN LONDON

At the upcoming EuroLab Automation program, scheduled for October 24-27 in London, there will be an interesting presentation. Titled *Clinical Laboratory*

*Automation Case Studies*, it has an intriguing description. Now that the clinical lab automation has matured in Japan and North America, there are many important lessons to be applied to those who are faced with the job of purchasing automation. This session is designed to allow us to learn from the successes and challenges of working automated laboratories. Each presenter will be asked "If you had to do it all over again, would you have done it the same way?"

## MORE ON: LAB AUTOMATION

Many lab executives and clinical pathologists would certainly like to learn what the candid confessions of the TLA pioneers in the United States will be when they answer that question. Throughout the second half of the 1990s, there was much debate about the effectiveness of total laboratory automation (TLA). First generation installations delivered in the United States struggled to deliver the productivity and financial benefits that were expected.

**That's all the insider intelligence for this report.  
 Look for the next briefing on Monday, October 23, 2000.**

# THE **LAB** REPORT

## ***UPCOMING...***

- ***Quest Diagnostics Gains ISO-9000 Certification in Three More Lab Divisions.***
- ***SmithKline Beecham Clin Labs' Aggressive Pricing Strategy: Post-Mortem Shows Why It Didn't Work.***
- ***Update on Web-Based Lab Test Ordering and Results Reporting.***
- ***Demand for Med Techs and Cytotechs Causing Management Crises in Some Regional Healthcare Markets.***