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From the Desk of R. Lewis Dark...

THE DARK REPORT

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

Restricted information, see page 2

Commentary & Opinion by...

R. Lewis Dark

Founder & Publisher

People Make The Difference

IN THIS ISSUE THERE ARE STORIES ABOUT THE SUCCESSES of **SmithKline Beecham Clinical Laboratories** (SBCL) and **UroCor**. Each company has a lesson to teach us about developing a business strategy, then making it work in the marketplace.

In the case of SBCL, I was astonished to realize that it has quietly become the *sole source* laboratory services provider for nine million people. Since late 1995, SBCL won national contracts from **Cigna**, **Prudential**, and **Aetna**. Current estimates are that 271 million people live in the United States; thus SBCL has captured an exclusive right to serve 3.3% of the population!

That is a remarkable achievement, regardless of whether you consider sole source contracts to be good for the laboratory industry or not. It's my opinion that a great amount of credit for SBCL's accomplishment in this area should be given to the individual who's been in charge of SBCL's national managed care effort. That individual is Vijay Aggarwal, Ph.D., who was given responsibility for SBCL's managed care back in 1994.

Critics can say that SmithKline's original willingness to enter into a sole source agreement with Cigna back in 1995 was folly, because of pricing, risk factors, and a mismatch between SBCL's laboratory infrastructure and where Cigna's beneficiaries lived. But two full years later, the program is still ongoing and neither party is seeking to tear it apart.

At UroCor, the achievement is to convert one-third of the office-based urologists into UroCor customers during a seven-year period. Starting from scratch in 1991, UroCor now has 2,500 of the nation's 7,500 urologists ordering diagnostic services from UroCor. Full credit should be given to Mark Dimitrof, the sales and marketing mind who doggedly built and managed the field force which sold those new client accounts. Dimitrof has been instrumental in converting UroCor's marketing and sales strategy from concept to reality during these seven years.

The accomplishments of these two individuals should remind us of two things. First, it is still possible to create a plan to expand a laboratory's market share, then go out and capture that new business. SBCL and UroCor represent the billion-dollar lab and niche diagnostics provider. Yet, big or little, both are progressing forward.

Second, success in managing laboratories requires exceptional individuals. These are people willing to volunteer for risky projects. They can visualize how to make things happen in the market, then hit the streets and make the fur fly. They are people who make the difference. My hat is off to Dr. Aggarwal and Mr. Dimitroff. We need more like them in our industry! TDR

SBCL Inks National Pact With Aetna US Healthcare

After a thorough RFP process, SmithKline to become sole source lab in seven states

CEO SUMMARY: As a corporate strategy, SmithKline Beecham Clinical Laboratories wants national contracts and exclusive provider status. The Aetna U.S. Healthcare agreement is SmithKline's latest victory. Both companies are moving rapidly to implement the contract. In many cities where Aetna has a large presence, SmithKline expects to gain a significant increase in laboratory specimens.

PERSISTENCE AND DEMONSTRATED experience allowed **SmithKline Beecham Clinical Laboratories** (SBCL) to capture a valuable prize in the battle for market share.

On September 18, **Aetna U.S. Healthcare** and SmithKline announced the signing of a laboratory services agreement between the two companies. SmithKline disclosed that the agreement was effective immediately.

"This contract represents a significant decision for both Aetna U.S. Healthcare and SBCL," stated Vijay Aggarwal, Ph.D., Vice President and Director, U.S. Reference Laboratories, SBCL. "It reflects an emerging demand for a unified laboratory organization with advanced information technology."

The agreement specifies that SmithKline is to be the sole-source laboratory provider for Aetna U.S. Healthcare's HMO and Quality Point-Of-Service programs in nine states: Pennsylvania, New Jersey, New York, Massachusetts, Connecticut, Texas, Florida, Louisiana, and Illinois. Approximately 2.7 million members are covered by Aetna in these states.

For all of Aetna's other programs and in other states where Aetna U.S. Healthcare operates, SmithKline will be a preferred provider of laboratory testing and related services.

From Aetna's side of the table, this new lab services contract begins implementation of a long-standing company philosophy. Aetna wants close, multi-year relationships with selected vendors.

Aetna's goal is to move away from contracts negotiated mostly on price and volume. Instead, the customer/supplier

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

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relationship should focus on how to develop win-win services which enhance the quality and profits of both companies.

"I suggest that Aetna's decision was not driven by price," said Aggarwal. "That is because Aetna U.S. Healthcare is already recognized for its success at controlling test utilization. Aetna's interest in long-term strategic supplier relationships is the key to understanding this agreement."

> ***"Several years ago, we decided that it was important to embrace managed care. That is why SmithKline is motivated to work with as many of the national HMOs as possible."***
>
> ***Vijay Aggarwal, Ph.D.***
>
> *VP & Director, U.S. Reference Labs, SBCL*

"You already see Aetna pursuing this strategy in the areas of home health care and radiology," noted Aggarwal. "It wants intimate business relationships with its chosen providers. Laboratory services was the logical next clinical area to begin this same process."

According to Aggarwal, Aetna's search for a clinical laboratory partner finally centered on SBCL for three reasons. "One, both companies shared a similar vision on the strategic use of laboratory and clinical information. Two, the capability to provide quality service national coverage was essential. And three, uniform testing practices and standardized ranges in all locations was important to Aetna."

Aggarwal characterizes this contract as unusual because SBCL will play multiple roles in how laboratory services are delivered to Aetna. "In some markets SBCL will be the exclusive laboratory provider," he noted. "In other markets, SBCL will take a lead role and coordinate lab services. We will develop a network of laboratories to provide testing services in those cities.

"Aetna's needs are what determined the level of service responsibility defined in this new agreement," he continued. "For example, in some markets Aetna is required to use integrated health providers. In other markets there are geographic gaps between where Aetna has patients and where SBCL has existing infrastructure. In several markets, technical testing capabilities determined how nearby laboratories would complement SBCL's capabilities."

During Dr. Aggarwal's interview with THE DARK REPORT, the theme of laboratory information continually popped up. "Unlike many healthcare companies, Aetna U.S. Healthcare funds an extensive internal development arm. Its use of clinical data sets is advancing rapidly.

"SBCL's demonstrated capability to deliver uniform data sets on laboratory testing across our entire system dovetailed neatly with Aetna's hunger for this kind of information," explained Aggarwal. "Both companies were impressed that each was looking at clinical information with the same intensity."

Lab Information System

Here is where SBCL's lab division may have a leg up on its two national competitors. SmithKline has a uniform lab information system which is functioning. Since implementation of the Cigna lab services contract in early 1996, SBCL has learned how to gather laboratory testing data and report it to its HMOs in a way that is useful to both companies.

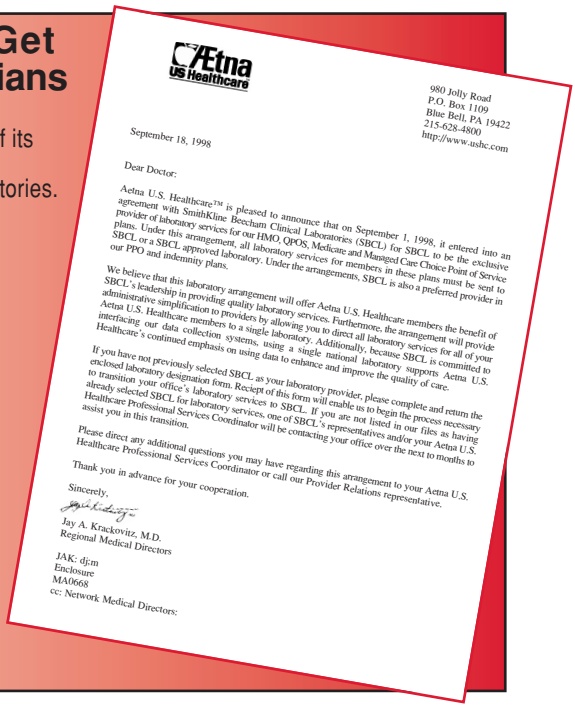
Thus, SBCL already has two year's experience in refining its data collection process. As a sole source laboratory provider for Prudential, it had a second opportunity to implement direct links between its national LIS and Prudential's IS.

This experience has also given SBCL a unique value-added capability,

Aetna Hustles To Get Word Out To Physicians

IT DIDN'T TAKE LONG for Aetna U.S. Healthcare to begin implementation of its laboratory testing agreement with SmithKline Beecham Clinical Laboratories. Medical Directors at the local Aetna U.S. Healthcare plans sent the letter at right to physicians in their service area. Dated September 18, the letter directs physicians to...

"If you have not previously selected SBCL as your laboratory provider, please complete and return the enclosed laboratory designation form. Receipt of this form will enable us to begin the process necessary to transition your office's laboratory services to SBCL... one of SBCL's representatives and/or your Aetna U.S. Healthcare Professional Services Coordinator will be contacting your office over the next two months to assist you in this transition."



Aetna US Healthcare

980 Jolly Road
P.O. Box 1109
Blue Bell, PA 19422
215-628-4800
http://www.ushc.com

September 18, 1998

Dear Doctor:

Aetna U.S. Healthcare™ is pleased to announce that on September 1, 1998, it entered into an agreement with SmithKline Beecham Clinical Laboratories (SBCL) for SBCL to be the exclusive provider of laboratory services for our HMO, QPOS, Medicare and Managed Care Choice Point of Service plans. Under this arrangement, all laboratory services for members in these plans must be sent to SBCL or a SBCL approved laboratory. Under the arrangements, SBCL is also a preferred provider in our PPO and indemnity plans.

We believe that this laboratory arrangement will offer Aetna U.S. Healthcare members the benefit of SBCL's leadership in providing quality laboratory services. Furthermore, the arrangement will provide administrative simplification to providers by allowing you to direct all laboratory services for all of your Aetna U.S. Healthcare members to a single laboratory. Additionally, because SBCL is committed to interfacing our data collection systems, using a single national laboratory supports Aetna U.S. Healthcare's continued emphasis on using data to enhance and improve the quality of care.

If you have not previously selected SBCL as your laboratory provider, please complete and return the enclosed laboratory designation form. Receipt of this form will enable us to begin the process necessary to transition your office's laboratory services to SBCL. If you are not listed in our files as having already selected SBCL for laboratory services, one of SBCL's representatives and/or your Aetna U.S. Healthcare Professional Services Coordinator will be contacting your office over the next to months to assist you in this transition.

Please direct any additional questions you may have regarding this arrangement to your Aetna U.S. Healthcare Professional Services Coordinator or call our Provider Relations representative.

Thank you in advance for your cooperation.

Sincerely,

Jay A. Krackovitz, M.D.
Regional Medical Directors

JAK: dj:m
Enclosure
MA/0668
cc: Network Medical Directors:

one that laboratory executives are advised to learn more about. SBCL's standardized test protocols and its uniform LIS system permit it to gather data and interpret that data in valuable ways.

Aggarwal explains. "In the past couple of years, we have learned that there is a remarkable variability in physician practice patterns within a managed care plan. It is a more astounding variation than anyone would have predicted without looking at the longitudinal data.

"As a result of the data sets we have, we've determined that there are many more short-term opportunities for appropriate intervention than we would have guessed just one year ago," he said. "We can now create data sets from actual patient data which clearly demonstrate this."

According to Aggarwal, when managed care executives look at blinded presentations of this data, they are quick to realize the value of this information. It permits them, in the short-term, to work with the physician outliers to improve test ordering patterns and clinical practices.

"Laboratorians generally know that physicians, when shown accurate data, want to move towards the best clinical practice," explained Aggarwal. "For managed care plans, this kind of laboratory information is win-win. Patients get better quality of care. Physicians appreciate accurate information that guides their clinical practices. And the cost of care is reduced."

If SBCL can bring this kind of information to managed care's table, then it is converting simple lab test results into information of greater value. Not only does that give it a jump on its two national competitors, but it puts SBCL into the forefront of using lab data to enhance the overall performance of clinicians at improving care while lowering costs. And those are precisely the outcomes managed care hopes to get from its laboratory providers. **TDR**

(For further information, contact Tom Johnson at SBCL: 610-454-6202.)

SmithKline's Strategies Now Delivering Benefits

SBCL may be quietly building a power base among the nation's largest managed care firms

CEO SUMMARY: Business strategy does make a difference. However, it sometimes takes years to appreciate the wisdom of choosing one strategy over another. In the case of SmithKline Beecham's lab division, the decision to become sole-source provider to the nation's largest HMOs may eventually prove to be a masterstroke. In coming years, sole-source arrangements may give SBCL a dominant national market position.

IN THE SECOND HALF of the 1990s, **SmithKline Beecham Clinical Laboratories** may be quietly carving a dominant position in the national marketplace.

Since 1995, it has notched sole-source laboratory testing contracts with three of the giant HMOs: **Cigna**, **Prudential**, and **Aetna U.S. Healthcare**. These three companies insure more than 9 million lives in their various HMOs and managed care plans.

Most laboratory executives fail to appreciate how SBCL's managed care business strategy will alter the marketplace for laboratory services. If SBCL continues to successfully bag sole-source managed care contracts with the nation's largest HMOs, the competitive position of both national and local laboratories will change.

Should SBCL's sole-source managed care business continue expanding, it will create two separate outcomes. One impacts its two national lab competitors. The other affects local laboratory providers in most urban areas of the United States

Alone of the three blood brothers, SBCL is carefully building a book of managed care business which is predicated on sole-source, long-term relationships with individual HMOs. The terms of these relationships will make it increasingly harder for competitors **Laboratory Corporation of America** and **Quest Diagnostics Incorporated** to break them apart.

Working Relationship

The reason is simple. Once a big HMO like Cigna or Aetna commits to a sole-source relationship with SBCL, a tight working relationship develops between the two companies. Each year brings about tighter business bonds.

Such an entrenched business relationship is difficult for any outside company to overcome. Thus, the effort required by LabCorp and Quest to wrest this business away from SBCL becomes tremendous.

Keep in mind that SmithKline's sole source strategy comes with great risk. If SBCL ever fails to effectively serve its customer, then it will be quickly kicked out the door. Doing business with a big

customer is great for increasing sales. However, if that customer ever goes elsewhere, the financial hit is huge.

But is SBCL at risk in this way? Probably not. The Cigna contract is now finishing its second full year. There is no market scuttlebutt which says Cigna intends to replace SBCL or bring in new laboratory providers. Neither Prudential or United Healthcare are sending signals that they want to radically downsize SBCL's role in their provider networks.

Given this marketplace evidence, it must be assumed that SBCL is performing acceptably where it has sole-source laboratory responsibilities. In fact, it must also be assumed, with the announcement of the new Aetna contract, that SBCL is becoming increasingly proficient at serving the needs of national HMO companies.

"Think of the 1996 Cigna contract as SBCL version 1.0," said a managed care specialist from a competing laboratory. "Two years later, SmithKline is probably on SBCL version 3.0 with Cigna. Each version gets better, both in performance of basic testing and at including new features which Cigna likes."

Developing Experience

"I would bet that SmithKline is benefiting from its ongoing experience at Prudential and United Healthcare in the same fashion," he continued. "This means SmithKline is developing experience, capabilities, and services which don't exist at the two other national laboratories.

"This is important to the managed care companies for a simple reason," said the executive. "If you want the benefits of going to a sole-source laboratory provider for your national network, wouldn't you want a laboratory that's already done it... more than once? Or, would you want to bet your corporate career on a laboratory which has yet to have that responsibility?

"That's why it's a safe decision to pick SmithKline Beecham," this executive answered, "Among other reasons, that probably contributed to their winning the Aetna contract last month.

"If this pattern continues with other HMOs, it spells danger for LabCorp and Quest," he explained. "The national labs need these national contracts to survive. Such contracts justify their existence.

"The three national laboratories need access to the patients of the national HMOs if they are to maintain their market presence in urban areas," concluded this executive. "That is why this is a critical battleground for them."

The next big laboratory services contract award is **Oxford Healthcare**. Quest is currently perceived to be the leading candidate for that contract.

SBCL's Early Decision: Embrace Managed Care

EARLY IN THE 1990S, SmithKline Beecham Clinical Laboratories made a critical business decision concerning managed care.

"As managed care began to appear in various cities, we realized that we needed to reexamine our business strategy," said Vijay Aggarwal, Ph.D., Vice President and Director, U.S. Reference Laboratories, SBCL. "After much reflection, we decided to embrace managed care.

"At the time, our studies indicated that managed care would continue to expand its influence upon healthcare," he added. "As managed care grew over time, SBCL would need to be more than just a producer of laboratory test results. We would need to become a full partner with both managed care companies and the clinicians.

"Integrated healthcare and prospective payment fundamentally change the way laboratories operate," said Aggarwal. "Once SBCL made the decision to embrace managed care, it required us to begin transforming our laboratory company toward a new business model for the future."

However, SBCL is also knocking on that door attempting to wrest the Oxford contract away from Quest.

Quest has a lot at stake, because Oxford's beneficiaries are mostly located in the Northeast, traditionally a strong market for Quest. If SBCL were to win that contract, it would pick up a significant volume of specimens, at the expense of Quest.

Impact On Local Labs

Local laboratories will find themselves impacted by SBCL's sole-source contract victories. During 1996, many labs saw their Cigna lab specimens disappear to SBCL and its contracted laboratory network. In certain cities the Aetna contract will similarly redirect laboratory specimens away from local labs and directly to SBCL.

However, the equation is not that simple. Healthcare remains a local business. THE DARK REPORT sticks by its prediction that most laboratory services will be delivered locally by regional laboratory systems anchored in that area.

The economics of testing, combined with ever-lower reimbursement, will work against transporting lab specimens hundreds, if not thousands of miles. This is particularly true in any city where unused laboratory capacity exists.

New Lab Business Model

A surprising new business model for laboratory operations may be emerging as a result of the sole-source laboratory contracts that SBCL is winning. That business model calls for SBCL to be the "network operator."

SBCL is the responsible entity, the supplier of laboratory testing to the HMO's physicians. As the "network operator" SBCL will utilize the best combination of laboratory resources necessary to deliver testing services to that locality.

In cities like Philadelphia and Miami, where SBCL has large regional laboratories, testing will be done internally. But in cities where SBCL lacks the infrastructure, it will contract with local laboratory resources to get the work done.

In fact, this was how SBCL cobbled together the laboratory resources needed to serve the Cigna contract back in 1996. It will use a similar approach to create the provider network required for the Aetna contract.

As the operator of these laboratory "networks," it is SBCL's responsibility to supervise the testing, respond to problems, bill for tests, and report results. In addition, and very importantly, SBCL will aggregate the test data from all regions and feed it to the HMO. It can also provide clinical outcomes studies that involve laboratory test data.

Incentives Motivate HMOs

Laboratory executives should understand that operational and economic incentives motivate national HMOs to do sole-source, national contracts. SBCL, LabCorp, and Quest have similar incentives to bid for that business.

For these reasons, national deals will not disappear. But at the physicians' office level, the need for superior service, delivered day after day, will never disappear. The clinician's need for value-added laboratory information will continue to increase.

This is where opportunity for local laboratories can be found. All three national labs lose business to local laboratories which compete intensely for the business. This is the dichotomy between a national contract and local service.

That is why aggressive local laboratories will continue to hold their own. And remember, SBCL's contracts for 9 million people nationally still leave another 262 million people who require laboratory testing. It remains a big market with plenty of room for tough competitors. TDR

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

Sales & Marketing News

UroCor's Sales Team Continues To Achieve New Sales Milestones

AT A TIME WHEN MANY clinical laboratories are experiencing a lack of growth, **UroCor, Inc.** of Oklahoma City continues its expansion of diagnostic services.

Recently the company announced an important milestone. At the end of third quarter 1998, UroCor now services 2,500 of the nation's 7, 500 office-based urologists. This gives UroCor a 33% penetration of the urology marketplace.

"This is a major strategic accomplishment for us," said Mark Dimitrof, VP and General Manager of UroCor's UroDiagnostic Group. "We also hit another benchmark, which is that 50% of our client physicians use more than one of our diagnostic products and services."

Clients of THE DARK REPORT are familiar with UroCor. It offers disease management services to urologists and has been a fast-growing business through the 1990s. *(See TDR, June 23, 1997.)* Much of UroCor's success derives from the company's effective application of sales and marketing techniques.

Unlike most laboratories, UroCor uses the number of client accounts as one way to evaluate market share gains and effectiveness of its sales team. "Our business strategy recognizes that other items besides revenue drive success," explained Dimitrof. "We believe measuring client account penetration along with multiple product usage gives us better information about how the entire company is performing."

As the chart below demonstrates, UroCor's sales team is bringing in new business at a rapid pace. Starting with five sales reps in 1991, UroCor now has 60 sales "resources" in the field. Their performance proves that good sales strategy can still drive growth in the lab industry. **TDR**

(For further information, contact Mark Dimitrof at 405-290-4000.)

UroCor's Market Penetration of Urologists

	Number of Customers	% Increase In Customers	% Penetration	% of Multiple Product Users
1991	380	N.M.	5.1%	13%
1992	620	63.2%	8.3%	19%
1993	1,030	66.1%	13.7%	24%
1994	1,250	21.4%	16.7%	34%
1995	1,320	5.6%	17.6%	41%
1996	1,895	43.6%	25.3%	48%
1997	2,150	13.0%	28.6%	48%
1998-Q3	2,500	16.0%	33.3%	50%

Source: UroCor financial statements

Demonstrates Benefits Of Laboratory Collaboration

Washington State's PacLab Network Is A Regional Winner

CEO SUMMARY: As a regional laboratory network, PacLab is unusual in one respect: participating hospital laboratories did not meet endlessly to talk about what they should do. Instead, action was the operative word for these network organizers. Since becoming operational in 1996, their bias for action has rewarded all participating laboratories. Test volumes are up and average cost per test is declining. PacLab offers other regional laboratory networks valuable lessons on how to make things happen. PacLab also validates the concept of lab networks.

PART ONE OF TWO PARTS

REGIONAL LABORATORY NETWORKS are probably the most difficult clinical laboratory organization to create and operate. Throughout the United States, many have tried, but few have succeeded.

Yet regionalization of laboratory services is an essential survival step. Without it, few existing clinical laboratories will successfully adapt to the fast-approaching world of integrated healthcare, capitation, and prospective reimbursement.

In Washington state, organizers of **PacLab Network Laboratories** solved many of the political, operational, and control issues which derail most organizers of regional laboratory networks. PacLab links nine hospitals and one independent commercial laboratory and offers services throughout Washington.

"In hindsight, what made this network come together was a realization by all participants that everybody had something unique to contribute," said Thomas Tiffany, Ph.D., CEO of **Pathology Associates Medical Laboratories** (PAML) of Spokane. "Simply put, the network could be more than the sum of its parts. But to realize those benefits, all participating laboratories had to concede some control and work together."

Tiffany's remarks were made at the *Executive War College*, held last May in New Orleans. PAML is the commercial laboratory partner for PacLab and provides a number of contract services to the regional laboratory network.

"PacLab was formed as a limited liability company (LLC) on November 1, 1996," observed Dr. Tiffany. "It is owned by three member organizations: **Catholic Healthcare West**, represented by **Franciscan Health Services**; **Sisters of Providence of Washington**; and PAML (a for-profit corporation owned by **Sacred Heart Medical Center** in Spokane. Ownership percentages in PacLab were determined by the amount of revenue brought in by each partner.

"The creation of PacLab was in response to efforts to socialize healthcare," noted Dr. Tiffany. "Many people remember when the Clinton Administration took office and made it a priority to create their national health insurance plan. But few people are aware that the State of Washington was racing ahead of Washington DC to establish its own comprehensive health plan.

"In 1993, then-Governor Lowery, a Democrat, rammed through a healthcare bill that was going to significantly impact all medical services providers. That law caused people who previously had no desire to talk or work together to begin discussions.

"Even though a new Republican legislature subsequently repealed Governor Lowery's healthcare plan, by now hospitals, physicians, and laboratories understood the threat," he continued. "Thus, the first key to PacLab's success was motivated organizers who recognized the need to act quickly, before the hammer fell on them."

Second Key To Success

"The second key to PacLab's success was that we had attention, involvement, and commitment by the highest levels of decision makers in our participating laboratories," Dr. Tiffany stated. "You have to have the right people at the table. In PacLab's case, these were the CEOs and COOs of the hospitals, CFOs, laboratory administrators, medical directors, and pathologists. We were fortunate to get all these people together. Over time, these people established a bond of trust.

"This was the foundation for subsequent decision making," added Dr. Tiffany. "We had all levels of authority involved in the PacLab project from the beginning. As mutual trust and confidence were established, PacLab rapidly took shape."

According to Dr. Tiffany, the third key to PacLab's success involved the test mix. PacLab made it a priority to offer value-added services while simultaneously lowering the hospitals' cost of laboratory testing. "Early on, it was decided the best way to accomplish this was to internalize reference testing. At the same time, we wanted to use effective sales and marketing programs to build outreach testing volume at each participating hospital."

Here is where PacLab's organizers made a critical decision that insured the rapid growth of the regional laboratory network. "As operators of a commercial laboratory [PAML]," stated Dr. Tiffany, "we know what office-based physicians want from a clinical laboratory provider. In meetings with the hospital laboratory directors, we were able to help them understand that PacLab's competitive advantage had to derive from delivering high levels of customer service."

Professional Sales Program

PacLab's organizers also argued that the network's success required a professional sales and marketing program. "Provider status with managed care contracts was a major goal at PacLab," said Noel Maring, Director of Marketing at both PAML and PacLab. "To attain this, we needed to be a significant lab services provider in each market served by our hospital laboratories.

"We determined that, if PacLab had a market share exceeding 20%, this would accomplish two things," he continued. "First, it meant that managed care companies had to include PacLab at the contract negotiating table. Second, a 20% market share would give PacLab the necessary testing volume to keep costs low and provide the cash flow necessary to support patient service centers and other services needed to be a managed care contract provider."

Quickly Caught On

"Hospital laboratory directors caught on quickly to the importance of sales programs and pro-active customer service for physician office accounts," added Maring. "They realized that the three national laboratories spend a lot of money on sales people to gain market share. PacLab needed to make similar investments if it was to wrest market share away from the national labs."

Another key element in PacLab's strategic plan was to avoid constructing new laboratory capacity. "We wanted to utilize all existing lab capacity at each network laboratory site," stated Dr. Tiffany. "By increasing outreach specimen volume and internalizing reference send-out work when ever possible, we could gain economies of scale at each site."

PacLab's operational structure sets it apart from most other regional laboratory networks. "Since PacLab is a limited liability company (LLC), it meets the needs of the for-profit and not-for-profit participants," Dr. Tiffany said. "PacLab acts as an agent for the member hospitals. PAML is the managing partner and provides billing, marketing, finance, information services, and management support to the network."

Ideally Organized For Role

PAML is ideally organized for this role. It is a commercial laboratory that is owned by a hospital. "We have a 30-year history of working with hospitals on projects similar to this," stated Lawrence Killingsworth, Ph.D., Chief Science and Technology Officer at PAML and PacLab. "Hospital labs within PacLab can see that we are a commercial laboratory which knows the physicians' office marketplace, but understands intimately the different needs of hospital laboratories."

"PacLab is an agency-model network," stated Maring. "There are no assets and there are no employees of PacLab. PAML provides management services under contract. For example, Stu Adelman is the PacLab Administrative Director, but is an employee of PAML.

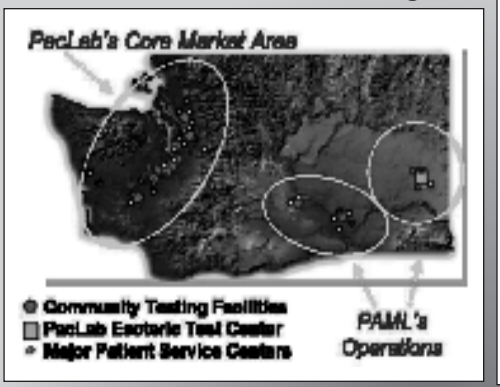
"Each participating laboratory contracts to furnish PacLab with specific services," he continued. "Each participant provides logistics, client services, testing, patient service center support, phlebotomy, specimen processing, and reporting. For the most part, this utilizes existing lab resources.

"PAML acts as the service integrator," Maring observed. "It provides reference testing and IS links among the participating laboratories throughout the state.

"PacLab divided the state of Washington into logistical service

PacLab Network Moves Forward With Shared Services, Logistics

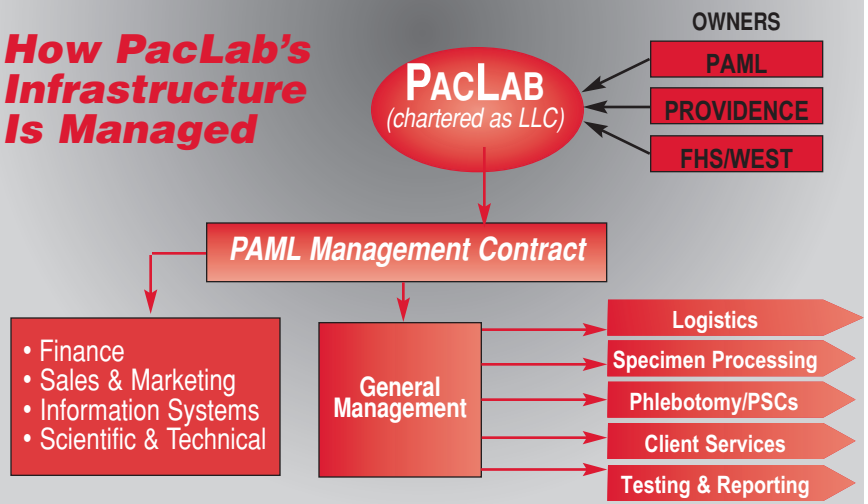
PacLab's Statewide Coverage



PacLab's Participants & Operational Facilities

- St. Joseph Medical Center, Tacoma
- St. Clare Hospital, Lakewood
- St. Francis Hospital, Federal Way
- Providence General Med Center, Everett
- Providence Pacific Clinic, Everett
- Providence Seattle Medical Center
- Providence St. Peter Hospital, Olympia
- Providence Hospital, Centralia
- Providence Yakima Medical Center
- PAML, Spokane
- PAML, Bellevue
- PAML, Olympia

How PacLab's Infrastructure Is Managed



regions," said Maring. "Each partner manages a specific service area. It gives PacLab a service edge on competitors because each PacLab partner is responsible for servicing its local area. We believe PacLab has superior service capability when viewed against other laboratory competitors.

"For example, in most areas of Washington, PacLab can provide same day results for routine tests," he added. "That gives PacLab an edge, since most commercial lab competitors require 24 hours to report routine test results."

Money is a big issue when starting regional laboratory networks. PacLab organized itself with that in mind. "One major goal of PacLab was to minimize the capital requirements for start-up," recalled Dr. Tiffany. "We did a detailed business plan with revenue projections and expected costs. A return on investment (ROI) was calculated. It was decided to fund enough capital to sus-

tain operations for six months. About $1.4 million in start-up capital was provided to PacLab by its partners."

PacLab also recognized the benefits of including a commercial laboratory as a partner. Much of PAML's existing business infrastructure could be used to good advantage by PacLab. Dr. Tiffany explained, "PAML did have a state-wide courier network already in operation. Because we provide reference testing to a number of hospitals, we also had a laboratory information system (LIS) capable of linking individual laboratories.

"In addition, PAML had a billing and collections department, accounts receivable/payable capability. We also had management expertise in budgeting, forecasting, financial reporting, marketing, and sales management," added Maring. "PacLab had immediate access to these resources without making any up-front investment."

Reimbursement Formula

Another sticking point with many regional laboratory networks is how to reimburse member laboratories for the testing they perform under network contracts. "PacLab uses a simple formula," said Maring. "Each hospital is reimbursed for the tests it performs using a marginal test cost (MTC) calculation.

"The MTC for each test is based upon its direct cost plus a small profit factor," he continued. "MTC's are evaluated periodically, to encourage cost reduction efforts at each laboratory site. As PacLab gets more efficient, MTCs are calculated to reflect this efficiency.

"MTCs reinforce PacLab's worth to the hospital administrators for two reasons," observed Dr. Tiffany, "First, they see the cost per test in their lab declining. This lowers their inpatient testing costs. Second, as an agency network, PacLab distributes excess cash flow back to the partners. Lowered MTCs mean increased partner distributions. Hospital administrators see clear benefits accruing from their investment and participation in PacLab."

Maring pointed out another advantage to using MTCs. "Each laboratory partner is free to choose which tests they will perform for PacLab. To provide testing, member labs must meet criteria for turnaround time in their local market, have state-of-the-art technology, and have expertise in that area of testing. Each laboratory can judge its capabilities against these criteria and decide which tests it will perform for PacLab."

Oversight of PacLab's business activities is done by the PacLab Financial Committee. Each partner's Chief Financial Officer participates. "Having the hospital CFOs actively involved in the network is a big advantage," stated Maring. "They see the direct benefits the PacLab brings to their individual institutions, plus they have the business savvy to appreciate the economic gains that PacLab is delivering."

PacLab's performance since launching operations demonstrates the effectiveness of its business planning and implementation. On the cost side, improvement is dramatic.

"During our first year, we reduced the cost of operation by 12%," noted Maring. "Projections indicate that we can continue to drive down costs by an average of 7% to 8% per year for the next three to five years."

Big Sales Increase

PacLab's revenue performance is equally impressive. "Sales and marketing efforts generated an annualized $3 million increase during our first year," said Maring. "We are also proud of another fact. Our PacLab sales reps averaged new sales of almost $6,000 per month per rep during this period. That's about 50% better than industry standards in the Washington market."

According to Maring, market share for PacLab also increased. "At the time of inception, we estimated that PacLab had a statewide market share of between 12% and 14%. Today, we estimate our market share is now at least 25%.

"PacLab's sales reps got an extra boost with the addition of four significant managed care contracts," added Maring. "In total, those contracts represent about 300,000 lives. This is a large number for Washington, where managed care penetration is less than other states."

More Bang For The Buck

These are impressive numbers. It certainly demonstrates that PacLab's business model for a regional laboratory network delivers more bang for the buck than the shared-testing model used by many regional laboratory networks.

PacLab's secret is that it was organized like a business, capitalized like a business, and managed by people who run the laboratory network using established business principles. Six main features contribute to PacLab's success.

First, PacLab was designed to use existing laboratory resources in more effective ways. As a network, PacLab is more than the sum of its individual laboratories. That brings value to all the partners.

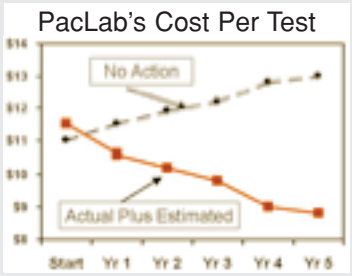
Second, PacLab understood the importance of providing value-added clinical testing services in the marketplace. Physician clients would only swich if they recognized that PacLab's services were better than those of competing laboratories.

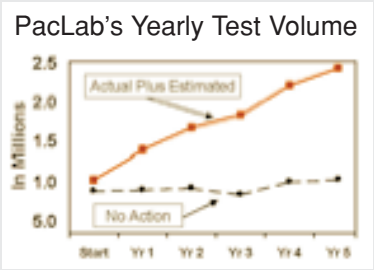
Third, and equally important, PacLab knew that a professional sales and marketing program had to be funded to support the network's success. PacLab's testing services would have no value if prospective physician clients were unaware that PacLab was a viable alternative to competing commercial laboratories.

Fourth, PacLab was organized in such a way that it generated income to pay for the ongoing expenses of operating the network. Failure to address this critical business requirement has been the fundamental weakness of regional laboratory networks organized to "lower costs" by shared testing.

Fifth, PacLab's hospital administrators recognized the value of partnering.

PacLab Lowers Cost Per Test, Increases Specimen Volume





These graphs show how PacLab improves the performance of its member labs. One line shows "no action," representing the financial position in PacLab had not been created. The "actual plus projected" line shows how PacLab makes these labs more competitive, stabilizing employment and increasing profits.

Their commercial laboratory partner provided them with a range of business capabilities and management experience, at a very low cost.

Sixth, PacLab understands the importance of leadership. It funds the position of network director, and senior executives from participating hospitals play an ongoing role in guiding the network's operations. TDR

(For further information, contact Thomas Tiffany, Noel Maring, and Lawrence Killingsworth at 800-541-7891.)

COMING ...

PART TWO: *How PacLab standardized technical, scientific and operational practices among participating laboratories.*

Analysis & Insight

Pathology PPMs Unlike Most Other PPM Firms

Unique characteristics of pathology profession make it different than office-based specialties

By Robert Michel

SECOND IN A SERIES

PHYSICIAN PRACTICE MANAGEMENT (PPM) companies have arrived at pathology's doorstep. For better or worse, a new era is pushing its way into the pathology profession.

In the first installment of this exclusive DARK REPORT series, we exposed the rotten secret behind the "growth by acquisition" strategy. *(See TDR, September 8, 1998).* "Acquisition only" strategies are no guarantee of ongoing financial stability.

Market Discipline

PPMs are subject to the same market discipline as companies in other industries. A company which is growing by acquisition must also meet and exceed the expectations of their customers on a daily basis by delivering superior service. If not, then large size is not an automatic guarantee of profitibility and success.

In this installment of our special series, we investigate the differences and similarities between pathology-based PPMs and other types of PPMs. The practice of pathology is fundamentally different from other hospital-based physician specialties. In the same manner, the practice of hospital-based medicine is different from that of office-based medicine.

The raging debate among many pathologists today is "should we sell our practice, or should we continue as we are?" Answering this question requires two fundamental assessments.

First, what is the reason to offer the pathology practice for sale at this time? What goals are served by the sale?

Second, if the decision is made to sell the practice, is there a certain type of buyer which is preferred? It is counterproductive to sell to the wrong buyer, since the selling pathologists must deal with the consequences of a bad decision for years to come.

In order for a pathology practice to properly assess both components, it is important that they understand the basic business characteristics of their profession. Pathology is a world apart from other physician specialities.

Don't Interact With Patients

Within the hospital, pathologists are the only practice specialty which does not see patients on a face-to-face basis. Emergency room surgeons, radiologists, and anesthesiologists all interact personally with their patients.

But pathologists are the invisible provider. Clinicians appreciate pathologists' role. But ask a patient to describe

what a pathologist does, and most patients will think of Jack Klugman as the TV pathologist in *Quincy.*

Why is it relevant that pathologists don't see patients? Because it means that many pathology services can be provided off-site from the hospital. That is not true of other hospital-based physicians.

Besides anatomic pathology (AP), pathologists are typically involved as medical directors and administrators of the hospital's clinical laboratory (CP). Again, this function does not require face-to-face interaction with the patient.

Compared to other hospital-based physicians, the clinical procedures handled by pathologists can be organized in a variety of business settings. Many hospitals do not require a full-time pathologist on site every hour of the working day, unlike, say, radiology and emergency room physicians.

Hospital Administrators

Consequently, hospital administrators have a number of options for contracting AP and CP services. For example, one pathology practice can contract to serve several hospitals, scheduling a pathologist to be on site for a minimum number of hours per week. The majority of AP specimens can be processed and diagnosed from an off-site location.

The key point here is that, compared to other hospital-based physicians, anatomic and clinical pathology services can be provided through a variety of professional business models. These business models can be located away from the hospital itself.

Next, let's look at differences between a hospital-based physician and an office-based physician. The most relevant difference is how the physician accesses patients, because money (reimbursement) follows patients.

Office-based physicians can build their patient base using all the tools available to independent businessmen. Office-based physicians are free to choose a small office setting, a group practice, or a multi-specialty clinic.

The office-based physician also has more flexibility to participate in various reimbursement options as payment for his services. Whether capitated, PPO or discounted fee-for-service, there is usually some wiggle-room to adjust payment terms.

Contrast that with a hospital-based physician. The patient case load seen by a hospital-based physician is dependent

Analyst Provides Warning Flag

"I would advise any investor or physi-cian evaluating a PPM to look at that PPM's balance sheet," said an indus-try insider in an off-the-record inter-view with THE DARK REPORT.

"If I see that 70% to 80% of that PPMs assets are goodwill, then I recommend avoiding that compa-ny," he continued. "Here's why. Goodwill is the excess of purchase price over assets. If a company's net worth is mostly goodwill and simi-lar intan-gibles (like the value of hospital or managed care con-tracts}, then it is a sign that the PPM has proba-bly paid too much for the cash flows it acquired.

"The recent huge losses at PPMs like* MedPartners *and* PhyCor *result from write-downs taken on goodwill," said the analyst. "They used accounting rules to generous-ly pay for physician practices. The ability to squeeze more revenues from these practices proved an impossible task. In my opinion, the PPM industry has more hard times ahead and physicians should excercise caution before selling their practice to a PPM."

on that hospital's daily census. If hospital in- and outpatient admissions decline, then the hospital-based pathologist has limited access to other patients.

Further, reimbursement for these patients comes to the hospital-based physician differently. For Medicare patients, there is probably a contract between the hospital and its pathology practice. Private payers and patients are billed for non-Medicare services.

Frequently the hospital contract has a 90-day cancellation clause. In a true sense, the pathology practice serves the hospital at the hospital's convenience. Whenever the hospital wants to make a change, it generally holds a stronger hand than the pathologists. (He who has the gold, makes the rules.)

Intrinsic Differences

Given these intrinsic differences in how a hospital-based pathology practice contracts for services, it becomes easier to see why a physician practice management company does not automatically bring a better solution to pathology practice management.

PPMs say they can bring superior business administration skills to the pathology practice. They can also bring volume purchasing discounts for supplies and other consumables.

A PPM can certainly do that for a group or large clinic. In those practice settings, many patients per day flow through the examining rooms. A large staff is needed to support the physicians. Large quantities of supplies and consumables are required.

But compare this with pathology. The vast majority of pathology practices number five pathologists or less. The hospital provides their equipment, their staff, and their office space. Obviously there is little opportunity for a PPM to "add value" in the business administration of the pathology practice.

Next, PPMs say they can help market the physician's practice and build patient volume and revenues. But how does a typical hospital-based pathology practice get more specimens? It relies on the hospital's daily census for the lion's share of its specimens.

To get more specimens, it must get additional hospital contracts. But that usually means taking the hospital's contract away from the pathology practice which served that hospital for decades. That is an unlikely scenario.

Outreach Specimens

Or, the pathology practice can solicit specimens from the outreach market. But those AP specimens already go to another laboratory. It requires expense, time, and persistence to build a sales outreach program for AP. Can a PPM afford to do this for most pathology practices, which number only two or three pathologists? Probably not.

Finally, how stable is a pathology PPM when it acquires a hospital-based practice receiving much of its money from hospital contracts with a 90-day cancellation clause? There is certainly no underlying security to protect the pathology practice and its affiliated PPM if the hospital were to seek a new pathology provider.

New Phenomenon

PPMs dedicated to pathology are still a new phenomenon. But for the past eight years, other types of PPMs have actively transformed the world of the office-based physician.

For better or for worse, PPMs have irrevocably changed the practice of medicine. But will PPMs improve the profession of pathology? That question remains unanswered. TDR

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

COMING...

PART THREE: *A look at the different pathology PPMs and their business strengths and weaknesses.*

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Specialty Laboratories continues to make inroads as a national reference laboratory. **Amerinet** selected Specialty as a clinical laboratory service provider. It joins **LabCorp** and **Quest** on Amerinet's laboratory provider panel. Specialty is aggressively repositioning itself from an esoterics provider to a routine esoterics provider. Earlier this year **VHA** added Specialty to its laboratory provider panel.

AmeriPath, Inc. just beat the quarterly bell with two more pathology practice acquisitions. This time its **Consultant Pathology Associates, Inc.** of Youngstown, Ohio (15 pathologists) and **Texoma Pathology Associates** in Dallas (two pathologists). AmeriPath generally announces its acquisitions at the end of each financial quarter. These two pathology practices represent about $8.5 million per year in revenues.

SBCL AND KAISER INK BIG CONTRACTS WITH NEOPATH

Automated cytology technology is making its first major inroads into the clinical community. During the last 30 days, **Kaiser Permanente** and **SmithKline Beecham Clinical Laboratories** signed contracts to acquire and use **NeoPath, Inc.'s** AutoPap™ System for the primary screening of Pap smears.

ADD TO...NEOPATH:
These contracts are a significant validation of the AutoPap technology. Kaiser performs 1.4 million Pap smears per year. SBCL performs more than five million Pap smears annually. During the next 24 months, both companies intend to move all Pap smear screening to the AutoPap System.

More consolidation within the healthcare industry. This time its $16.5 billion **Cardinal Health, Inc.** acquiring $4.4 billion **Allegiance Corporation**. In a deal valued at $5.4 billion, the two companies will merge business operations. Most laboratorians know Allegiance as the former **American Hospital Supply** (AHS). **Baxter International** bought AHS in 1985. In 1995, Baxter spun off the hospital supply portion of AHS as Allegiance.

Dynacare Inc. will manage the laboratory services for **Baylor Health Systems'** HealthTexas Provider Network. As part of the agreement, Dynacare will develop and manage a new lab facility in Dallas. Expect Dynacare to use HealthTexas' 38 access points as a springboard for an outreach sales program.

Beckman Coulter Inc. will close two manufacturing plants during the next 15 months. The action affects 100 employees and involves plants in San Diego and Puerto Rico. Beckman is expected to continue rationalizing its corporate infrastructure in response to its acquisition of Coulter and other diagnostic companies in recent years.

That's all the insider intelligence for this report.
Look for the next briefing on Monday, November 9, 1998

UPCOMING...

- ***Bankruptcy Court Bidding War For Meris Labs Portends Competitive Shake-up In California.***
- ***Part Three Of Our Pathology PPM Series: Strengths And Weaknesses Of Current Players.***
- ***Survey Of Lab Executive Headhunters Reveals Surprising Employment Trends.***