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From the Desk of R. Lewis Dark...

THE DARK REPORT

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

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R. Lewis Dark

Founder & Publisher

Market Upheavals Around The Corner

In reviewing the galley proofs for this issue of THE DARK REPORT, I am struck by the potential for significant market upheaval in two areas of laboratory medicine: pathology and the clinical laboratory marketplace of California. The stories about **AmeriPath, Inc.** and California laboratories contain some interesting market analysis and predictions about future events.

For pathologists, AmeriPath's arrival as a publicly traded, pathology-based physician practice management (PPM) company is highly significant. Now that AmeriPath's shares are publicly traded, the company will be extremely sensitive to its stock price. AmeriPath must show consistent growth in revenue and earnings if it is to encourage investors to bid ever-higher prices for its shares. Traditionally, Wall Street likes annual growth rates to be consistently 8% to 15% per year. This is how it should be, as investors buy stock to make profits.

But the profession of pathology has traditionally been a quiet, stable corner of the healthcare community. How will AmeriPath, and those pathology PPMs yet to follow, achieve growth rates never before seen by pathology-based businesses? I am curious as to how the marketplace answers that question.

Short term, acquiring new pathology practices and aggregating revenues will produce growth. This is how **Columbia/HCA** and **MedPartners** grew so rapidly. But, at some point AmeriPath must take its existing pathology practices and show "same store" growth from one year to the next. Since pathology practices generally are not perceived as good sales and marketing vehicles, most of the pathology profession is waiting to see if this can be accomplished. It is AmeriPath's innovative strategies to capture more pathology revenues which will trigger the market upheaval in pathology which I predict.

For clinical laboratories in California, I concur with our editor's assessment. Major changes are ahead, and some surprising events will occur sooner rather than later. Having worked with large multi-practice specialty clinics in Southern California, I can tell you that managed care crippled the clinical laboratory business in this state. My colleagues and professional associates all have stories of poor service, lost specimens, improperly reported test results and billing confusion among the laboratories serving them. Changes clearly need to be made if laboratory clients are unhappy and laboratories themselves find it impossible to generate sufficient profits to remain open and offer a superior level of service to their physician clients. TDR

AmeriPath Successfully Completes Public Offering

Stock of first pathology-based PPM now trades on NASDAQ Market as "PATH"

CEO SUMMARY: AmeriPath's new status as a public company gives it even greater visibility than before. As the first public pathology-based physician practice management firm, AmeriPath has the potential to introduce many innovations into the business organization of pathology services. With the IPO behind it, AmeriPath now faces hard work.

WEDNESDAY, OCTOBER 22 was the milestone day for **AmeriPath, Inc.** of Riviera Beach, Florida. The completion of its initial public offering (IPO) made AmeriPath the first public pathology-based physician practice management (PPM) company.

AmeriPath sold 5.6 million shares of common stock at a price of $16.00 per share. Investor demand for shares was strong enough that underwriters exercised their overallotment for 600,000 additional shares of common stock. Observers think that the timing of Ameripath's IPO worked in the company's favor.

AmeriPath's offering raised $89.6 million. The original target in the offering prospectus was to get $13-$15.00 per share. Since AmeriPath sold shares at $16.00, the company generated more proceeds from the IPO than expected. Trading in the stock commenced Wednesday on the NASDAQ exchange under the symbol "PATH." Since Wednesday, shares have traded between $18.00 and $21.00.

Another month must go by before company officials will speak publicly. According to SEC rules, the "quiet period" continues for 24 days after the IPO date. During this time, company officials must refrain from public comments which could be considered as boosting the stock.

AmeriPath accumulated a sizable revenue base during the last 24 months. Annual revenues currently top $122 million. The company acquired 15 separate pathology practices in seven states. There are 127 pathologists affiliated with AmeriPath, along with 951 employees. AmeriPath operates 14 out-

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

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patient laboratories and has contracts with 72 hospitals.

Detailed coverage of AmeriPath's business plan and activities was presented in earlier issues of THE DARK REPORT. *(See TDR, January 27, 1997 and September 15, 1997.)* With the completion of AmeriPath's IPO, the hard work begins. Company executives must demonstrate that a pathology-based PPM can add value in the managed care marketplace.

The company's pioneering efforts to restructure pathology into a more effective and profitable business model will provide worthwhile lessons in new management concepts.

AmeriPath will pursue three basic management strategies. The first strategy is to grow through acquisition. AmeriPath can increase its quarterly earnings by buying additional pathology practices and "folding them in." If they do it successfully, it can boost the share price. Higher share prices can then enable them to use stock to buy additional pathology practices.

Acquisition Tactic

This acquisition tactic was used by **Columbia/HCA** and **MedPartners**. Both companies rapidly grew to billion-dollar size through acquisition. Both companies used the appreciating value of stock to partially pay for acquisitions.

AmeriPath's second strategy to watch is how the company increases revenue from year-to-year for its individual pathology practices. Wall Street calls this "same store" growth. For example, if AmeriPath owns a $5 million pathology practice, can AmeriPath increase those revenues by 10% in each of the next three years? To do so would require revenues to climb to $6.7 million in year three.

This strategy is intriguing for a simple reason. Historically, few pathology practices ever grew at such rates over a multi-year period. Should AmeriPath accomplish this, they will have done something seldom seen before in the pathology profession.

The third strategy is to consolidate operations and administration, thus cutting costs, improving productivity and realizing economies of scale. Like "same store" growth, this is unexplored territory within the pathology profession. No company has yet tried to put 127 pathologists into one business model. No example exists where pathology operations were consolidated and supported across a multi-state environment.

AmeriPath would defend its ability to deliver on these three strategies by pointing out the experience of other physician practice management companies, such as **MedPartners**, **PhyCor**, **American Oncology Resources** and others. These companies have demonstrated that it is possible to profitably implement all three strategies in a PPM setting.

Hospital-Based Specialty

However, unlike these other PPMs, AmeriPath must deal with pathology, a medical specialty that is primarily hospital-based. This provides some unique business challenges, and is why AmeriPath's successes and setbacks will be instructive. The company's pioneering efforts to restructure pathology into more effective and profitable business forms will provide worthwhile lessons in new management concepts.

Regardless of AmeriPath's future, its successful IPO last week represents a milestone event in pathology. The pathology marketplace is about to evolve in radical new ways. **TDR**

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

California's Rumor Mill Links LabCorp & Unilab

Speculation seems to fuel current rumors since neither lab seems under pressure

CEO SUMMARY: Continued financial pressure on all laboratories operating in California leads some industry observers to believe that Laboratory Corporation of America and Unilab might be considering some kind of deal between the two companies. Senior executives at both laboratories say such talks are nonexistent.

FOR ALMOST TWO WEEKS there has been ongoing speculation that **Laboratory Corporation of America** and **Unilab, Inc.** of Tarzana are negotiating some type of deal.

Unilab Director and former Chief Financial Officer Rich Michaelson pointed out that "although acquisition rumors involving Unilab have circulated in this business for the last ten years, never should they be more ignored than now. As the scale player in California, our priority is to refine our internal operations and not be distracted by acquisition activity."

LabCorp provided a similar statement. "As a matter of policy, we don't comment on potential activities involving acquisition opportunities or similar transactions," stated Brad Smith, Executive Vice President and General Counsel at Laboratory Corporation of America. "Any statements involving such activities would be released to the public as appropriate and in keeping with relevant securities law."

Unilab's financial progress during 1997 leads Michaelson to be optimistic and specific about the company's business strategy, which does not call for doing any outside deals. "The opportunities for us to improve the margins at Unilab are huge. So not being distracted by some outside deal is a desirable goal for us," explained Michaelson. "After emerging from this wrenching period where earnings hit bottom, the market is recognizing the progress made by Unilab during the last nine months."

Rise In Share Price

Michaelson is referring to the recent rise in Unilab's share price from 75¢ per share in June, to a current level above $2.00. "As we get our own operations in order, we don't see acquisitions as being necessary or even desirable. We believe we are in the early stages of regaining profitability to our existing book of business.

"Fact number two is that we have a stable balance sheet today," continued Michaelson. "Generally acquisitions tend to cost something. In light of our priority to focus internally, we would not want to weaken our balance sheet by acquiring business that is outside our own laboratory."

Michaelson did note the obvious qualifier to that statement. Given the

public knowledge of financial difficulties for laboratories in California, he realizes that Unilab would not categorically refuse to look at any deal offered to it. "Pick any company with laboratory operations," he said. "Were they to come to us and say that they wanted to exit the business in California, would we take it off their hands? With the right terms, we would probably kick the tires and consider a deal. But that's not likely to happen anytime soon."

No Substance To Rumors

With senior executives at both Unilab and LabCorp telling THE DARK REPORT that current rumors have no substance, why would such rumors crop up? An analysis of both companies' position in California indicates that there are two reasonable scenarios for a business deal between the two companies.

Scenario one says that LabCorp's California operations lack the size and critical mass necessary to generate acceptable profit margins. This is why LabCorp would consider selling its California operations to Unilab.

Scenario two says that LabCorp wants to acquire Unilab. That single step would make it the largest laboratory in California, with important business consequences. The acquisition would also give LabCorp the unchallenged position as the largest clinical laboratory company in the world.

What Drives Deals

"There are several reasons why either scenario makes sense for LabCorp," said one senior laboratory executive (not affiliated with Unilab or Labcorp) with experience in California. "However, it is important to understand what would drive any deal between laboratories in California, including LabCorp and Unilab. No public laboratory is 'making money' in California. The reimbursement picture in that state is so bad that it is outrageous. If you understand the difficulty of making money in California, then you understand why LabCorp might be motivated to restructure its California business. Since Unilab is dealing with the same marketplace economics, it would probably consider any option which might help the situation."

With senior executives at both Unilab and LabCorp telling THE DARK REPORT that current rumors have no substance, why would such rumors crop up?

In practical terms, Unilab, **SmithKline Beecham Clinical Laboratories** and LabCorp are the major commercial lab players in California. **Quest Diagnostics Incorporated** has a relatively small market share because **MetPath** made a strategic decision years ago to stay out of California.

"I estimate that LabCorp does about $65 million worth of testing in California," said the lab executive, "Most of that goes through its San Diego lab. It is my opinion that anything less than $100 million in California lab business makes it difficult to survive the financial situation.

"LabCorp's puzzle is: do they exit California to solve the problem, or is there a way to increase their business to give them the synergies they need?" he continued. "It is interesting that Unilab offers logical solutions to either approach. From Unilab's perspective, they are making enough money to service their debt, but they still must improve earnings to an acceptable level. Were a buyer to offer the right combination of price and terms, it would not be unreasonable for Unilab's existing shareholders to consider selling."

This executive had some particularly insightful observations about the state of affairs in California, and why LabCorp and Unilab would be motivated to nego-

tiate some kind of deal. "Reimbursement levels in California don't support a financially-viable laboratory," he said. "Medicare provides a perfect example of the economics of lab testing. At least 38% of California's Medicare population is enrolled in managed care versus 5% on the East Coast. So California labs do not get the same proportion of Medicare fee-for-service reimbursement as labs in other areas of the country.

"Managed care capitation rates for seniors average approximately $1.00 per member per month (PMPM) in California. When you do the arithmetic, the financial gap becomes obvious. Assume a well-run laboratory averages $9.50 per accession in direct costs (without G&A and overhead). The encounter incidence of a Medicare population is three times that of the standard population. For every 100,000 Medicare HMO beneficiaries, each month, 30,000 will need lab tests. That is $285,000 per month in direct costs, against a capitation rate which generates less than $100,000 in revenue. The laboratory is losing money on that Medicare HMO business from day one."

Similar Economics

"The economics are similar for the commercial managed care business," the lab executive continued. "After years of destructive pricing policies, the string has run out. The current reimbursement situation makes survival difficult for some laboratories, impossible for others," he explained. "Boards of directors are finally beginning to understand this."

However, some laboratories in California continue to pursue aggressive, below-cost pricing strategies. Even as Unilab learned this lesson and now strives to increase its contract pricing, there are reports that SmithKline Beecham Clinical Laboratories (SBCL) has chosen to aggressively offer discounted pricing. This is consistent with SBCL's stated corporate strategy of increasing market share and building specimen volume.

Laboratory competitors note that SBCL recently bid cap rates of 35¢-40¢ PMPM for a contract in Northern California. Such low cap rates demonstrate how difficult it is for laboratories in California to restore financially sustainable price levels for laboratory testing.

With financial relief to clinical laboratories in that state unlikely, THE DARK REPORT predicts that a major realignment of commercial labs will take place in California sometime in the next 12 months. *(See pages 7-8 in this issue.)* We believe that continuing financial struggles at **Meris Laboratories** and **Physicians Clinical Laboratories** will eventually be the catalyst for such marketplace changes. **TDR**

(For further information, contact Rich Michaelson at 201-525-1000 and Brad Smith at 910-584-5171.)

Haywood Cochrane Now Unilab Director

AS UNILAB RESTRUCTURES ITSELF to meet the realities of the California market for laboratory services, one important move was to bring Haywood Cochrane onto Unilab's Board of Directors.

Cochrane is familiar to most laboratory executives as the former CEO of **Allied Clinical Laboratories**, which was sold to **National Health Laboratories** (NHL) in 1994. Cochrane is a recognized deal-maker and served both NHL and LabCorp as an acquisitions specialist and the primary contact with the Wall Street financial community.

His involvement with Unilab's Board of Directors is a sign that Unilab will be taking different directions in the future. Cochrane is active in several heatlhcare-related start-up companies. His entrepreneurial perspective will definitely cause Unilab to develop new management strategies to meet the changing marketplace for laboratory services in California.

California's Lab Market To Undergo More Change

Rumors of potential acquisitions are a sign of continuing financial challenges in that state

CEO SUMMARY: Every laboratory in California continues to operate in a financially-punishing environment. Further shake-outs must occur as the economic forces unleashed by managed care take their toll on clinical laboratories. Expect radical changes to occur within the next 12 months.

RUMORS OF A DEAL BETWEEN **Laboratory Corporation of America** and **Unilab, Inc.** have no substance, according to executives at both companies. Yet even the rumors themselves are evidence that difficult financial pressure confronts all laboratories operating in California.

If California's advanced managed care marketplace is the model for managed care in other cities of the United States, then the future is grim. More financial pain awaits California laboratories as the sustained effects of rock-bottom reimbursement rates and excess laboratory capacity continue to deny laboratories in that state sufficient revenue to cover costs.

As reported by THE DARK REPORT during the past 24 months, at least four sizeable laboratories filed bankruptcy in California. **Medical Sciences, Inc.** (MSI) and **Physicians Clinical Laboratories** (PCL) filed Chapter 11 bankruptcy actions. **Watson Medical Laboratories** and **Diversified Medical Laboratories** were put into Chapter 7 bankruptcy, terminating operations and liquidating all assets.

At least one more laboratory already announced its intention to file a Chapter 11 bankruptcy. That is **Meris Laboratories** of San Jose. THE DARK REPORT predicts that another surprise bankruptcy may be filed in California during the next 12 months. Among smaller laboratories, expect to see some mergers, consolidations and bankruptcy actions during the same period as they struggle to remain in operation.

...during the past 24 months, at least four sizable laboratories filed bankruptcy in California.

The announcement by Meris of an impending Chapter 11 bankruptcy is surprising only because it took so long to occur. Observers say that the laboratory is bleeding significant red ink. Estimates are that the company requires a monthly cash infusion in excess of $500,000 to maintain operations. If true, this means that outside investors were willing to pump some $6 million per year into a laboratory operation which is doing less than $25 million in annual sales.

Another laboratory that might find itself in difficulty a second time is the former **Physicians Clinical Laboratories** in Sacramento. Once a public company with annual revenues of $110 million, PCL was forced into Chapter 11 bankruptcy in November, 1996.

At that time a white knight appeared in the form of J. Marvin Feigenbaum. Feigenbaum used a public company he controlled called **Nu-Tech Bio Med, Inc.** to acquire a 52.6% interest in PCL. As part of this transaction, Nu-Tech invested about $10 million of capital into PCL through the purchase of senior debt.

Meanwhile, Feigenbaum entered the bankruptcy proceedings of Medical Sciences, Inc. of Burbank and purchased this laboratory with the goal of merging it into PCL. The bankruptcy court discharged PCL's Chapter 11 action on April 18, 1997. After downsizing PCL and folding in MSI, it is estimated that PCL's revenues currently total less than $60 million annually. PCL now operates under the name **Bio-Cypher Laboratories**.

Negative Cash Flow

Those familiar with Bio-Cypher and its finances say that the laboratory is currently operating with a negative cash flow. They estimate that expenses could exceed revenue by as much as $1 million per month.

If true, Bio-Cypher faces a genuine dilemma. Unless current management can cut operating losses, find additional working capital or do both, they may find themselves forced to go to bankruptcy court for the second time in two years. Since the laboratory has already endured three years of extensive cost-cutting, options to squeeze out additional costs are limited.

Finding more working capital may prove to be impossible. Wall Street and lenders are still smarting from the financial damage they suffered as public laboratories hit financial bottom. Any capital extended to Bio-Cypher will come with a heavy price.

Regardless of whether Bio-Cypher finds itself in bankruptcy court a second time, it is clear that should Meris and Bio-Cypher fail to develop a positive cash flow, their financial problems may lead to further merger/acquisition activity among laboratories in California. TDR

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

Laboratory Creditor Sells Debt At Profit

ONE KEY PLAYER has effectively exited the California laboratory scene. In the process, it is probably the only investor to make money on California laboratories in recent years.

Oak Tree Financial *purchased a major portion of bank debt owed by Physicians Clinical Laboratories (PCL). Oak Tree sold a big chunk, at a profit, to Marvin Feigenbaum as part of PCL's financial restructuring.*

Oak Tree also purchased $23 million of Unilab's outstanding debt in January of this year when the debt was discounted to 63. As Unilab restored its debt service capability, discounts on Unilab's debt increased back into the 90's. Oak Tree recently took the opportunity to sell that debt and book a healthy profit of almost $5 million for its ten-month investment.

During the time that Oak Tree held significant debt in both PCL and Unilab, it was recognized as having both the motive and the legal power to attempt a consolidation between Unilab and PCL, if ever both those companies defaulted on their debt convenants. After liquidating its holdings in Unilab, Oak Tree effectively removed itself from any future involvement in Unilab. However, because it still owns a considerable piece of PCL's debt, it sits on the creditors committee and remains involved in PCL's financial affairs.

CEO SUMMARY: Presbyterian Laboratory Services represents one of the more advanced business models of laboratory consolidation found today in the United States. Owned by an integrated delivery system, the laboratory division serves six hospitals and a variety of outreach clients. Several elements set Presbyterian apart from other laboratory consolidations, including its consistently successful laboratory outreach program. First of a special two-part series, this installment explores how Presbyterian became the local laboratory powerhouse in Charlotte, North Carolina. In the next installment, we will explore how Presbyterian is adapting to managed care and looking to remain viable in future years.

Part one of a two-part series.

Consolidation At Presbyterian Encourages Regional Strategy

CONSOLIDATION of hospital laboratories is the dominant trend in the laboratory industry today. Yet few consolidation projects truly deliver the service benefits and improved revenues which should logically result from a well-executed consolidation.

An exception can be found at **Presbyterian Laboratory Services** (PLS) in Charlotte, North Carolina. In recent years, PLS gained recognition as one of the more innovative and financially successful examples of hospital laboratory consolidation to be found anywhere in the United States.

It is no accident that PLS is doing well at a time when most hospital laboratories are under extreme financial pressure. Leadership at PLS and its parent healthcare system, **Presbyterian Healthcare**, consistently chose to be proactive. Initiatives launched by administration received solid support from laboratory employees.

This combination of visionary administration and supportive laboratory staff enabled PLS to evolve from a traditional focus on inpatient testing to a viable regional laboratory organization with extensive outreach business.

In this first installment of THE DARK REPORT'S special two-part series on Presbyterian Laboratory Services, we look at why PLS originally consolidated its laboratories and how it's evolved since that time. Many of PLS's management strategies can be applied with equal success by consolidated laboratory organizations in other cities.

The change in philosophy goes back to 1985. "I started at Presbyterian in December of 1984," stated Bob Hamon, Administrative Director of PLS. "In February I got the first memo from our medical director suggesting that we should get into the outreach business.

"That memo launched a serious evaluation of what was required to be successful in outreach," he continued. "We soon realized that we needed to improve our inpatient services before going outside.

"By 1988, our outreach testing had climbed to $1 million annually. When Presbyterian acquired a 62-bed speciality hospital," said Hamon, "it gave us the opportunity to enhance both inpatient and outreach testing services. We convinced administration that it made sense to consolidate laboratories in both hospitals."

The next milestone for PLS was a common LIS platform. "In 1989 we made the decision to switch to **Cerner**. That was a major commitment of money by the administration. It was based on their belief that we could achieve our projections for continued growth in outreach specimen volume. They also allowed us to scrap an LIS system which had been installed only four years earlier. That illustrates the faith our hospital administration was willing to place in the laboratory.

" During 1990, as the LIS implementation project went forward, Leslie Sprick was hired to be our outreach marketing manager," continued Hamon. "This was one of the most important things we did to make our strategic plan succeed. We hired a professional who had experience in both the hospital-based reference lab as well as commercial laboratory sales and marketing."

Consolidation of the two hospital laboratories was accomplished by creating a core laboratory using a 15,000 square foot building located on the hospital property. This became operational in 1991, along with the new LIS system.

"The off-site core laboratory was important to us for more reasons than just consolidation of hospital testing," explained Hamon. "As our outreach efforts took root, we could see a certain amount of confusion among outreach clients and prospects as to who we were and how outreach services were provided from our inpatient laboratory. By moving the laboratory to a stand-alone building, we created

an identity in the minds of our clients. Just as importantly, the physician community saw our core lab as a long-term commitment by Presbyterian to serve the physician office market."

Obviously PLS was doing something right, because outreach revenues topped $3.5 million in 1992. "We sat down again in 1993 to reassess ourselves. Three strategic priorities resulted," Hamon said. "First, we initiated a cytogenetics program. We could see the competitive balance this would provide us. Second, we developed a toxicology program and got NIDA (now SAMSA) certification. Third, we undertook a major redesign of our laboratory management structure."

Restructuring management at this time was an interesting strategic move. Obviously PLS was successful and enjoying rapid growth. Why the need to shake up the status quo? "We subscribe to the "Darwin Theory" of management," noted Hamon. "This means we evolve and respond as we go. In 1993, we recognized that ongoing evolution of our reporting structure in recent years had left us with multiple layers of management. These impeded our ability to move forward."

Presbyterian Laboratory Services

At-A-Glance

Off-site Core Lab: *on Presbyterian Campus: 15,000 sq. ft. for lab; 10,000 sq.ft. for operations/sales.*

Composition:
6 hospitals.
2 hospital rapid response labs.
34 physician office labs.
6,350 SNF Beds
300+ outreach clients
100 toxicology clients
2 off-site patient service centers

Couriers: *7.5 FTEs, 7 vehicles*

Employees: *330*

Sales/Marketing: *1 Director, 3 reps*

Billing: *6 FTEs, bills under hospital.*

Service Area: *90 mile radius*

Managed Care: *30% of market*

Billable tests: *2.2 million*

Inpatient/Outreach Mix: *45%/55%*

Two Ground Rules

"Our response was to throw the organizational chart in the garbage can and start from a clean sheet of paper," he noted. "To pull this off, we had two ground rules. First, no existing job title could be used in the restructuring. Second, everyone in a management position would have to reapply for whatever new positions were defined. A total of 11 management positions ceased to exist as a result of this reorganization."

The restructure was successful, accomplished with a minimum of fear, internal politics and disruption. Hamon credits this to a universal recognition by all laboratory employees. They could see the need to be more efficient and understood that a new management structure was necessary to sustain existing growth rates.

"Our growth should not be overlooked as a success factor in the management reorganization," Hamon said. "Employees in the laboratory saw that our consistent growth over several years improved employment stability and created new career opportunities. They compared our laboratory experience with nearby hospitals. When they saw staffing cutbacks at those hospital and commercial laboratories, they appreciated the security and positive working environment available at Presbyterian Laboratory Services."

PLS backed the management reorganization with support for the new managers. "In 1994, we brought in a teamwork consultant to help us develop a new way of doing business and working together," explained Hamon. "If we

were to run the laboratory in a new way, we had to learn new management techniques of working together, organizing work flows and processes, and helping our staffs adapt. This teamwork consultant worked with us for about two and a half years."

In the year following the reorganization, Presbyterian acquired two more hospitals. "People visit us today and comment on how fortunate we were that our administration mandated that we consolidate all the hospital labs," recalled Hamon. "Nothing could be further from the truth. Remember, in 1994 few hospital laboratory consolidations were in existence. Back then lab consolidation was a radical idea. We had to be real sales people to convince the powers-that-be of the benefits of consolidating these new hospital laboratories into our existing structure.

"We got administration's buy-in because it was the right thing to do," he continued. "Consolidation permitted us to improve service, expand the test menu and lower test costs each year since then to all the hospitals we serve. However, in 1994, before all this happened, it was difficult for administration to recognize the value of these benefits and believe it was worth the trouble to consolidate the laboratories."

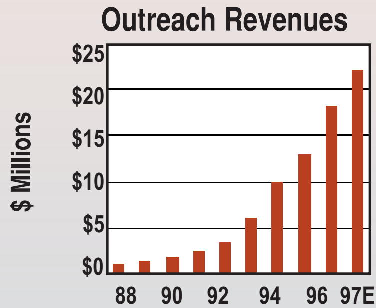
Backed New Managers

During 1994, PLS also took on another major chunk of business. "We contracted to run the laboratories for the **Nalle Clinic.** Managed by **PhyCor**, it operates in eight locations with 120 physicians," said Hamon. "This was a big deal for us. Besides the laboratory, Presbyterian was providing x-ray and EKG services.

"It was the highest profile client in town," he continued, "and we learned quickly that we were not totally prepared to properly serve such a client.

Presbyterian Sees Outreach Growth

STRONG MANAGEMENT LEADERSHIP at Presbyterian Laboratory Services is validated by the sustained growth in outreach testing. As outreach specimen volume increases, PLS generates lower testing costs to its hospital owners, while enhancing internal laboratory services to all customers.



For example, after we began providing services, we learned that our materials management system didn't support remote sites. On the positive side, we made a commitment to work through all these issues and give Nalle Clinic top service. Our success seems confirmed by the fact that Nalle Clinic recently renewed its contract with us for five years."

During 1995, PLS got the opportunity to expand its activities in physician office laboratory (POL) management. After 13 months of negotiations, PLS signed a contract to consolidate and operate 16 POLs for Presbyterian's physician network. "This gave us a real boost," stated Hamon. "We hired the best POL manager we could find. She helped us learn how to succeed with this segment of the business, and we focused our marketing to sign up more of these arrangements. Now we manage 34 laboratory sites in the community."

The results are impressive. In 1995,

Elimination Of A Laboratory Takes Place After Remodeling

WHEN PRESBYTERIAN ADDED an orthopedic laboratory in 1994, PLS immediately moved to consolidate microbiology and pathology into the core laboratory. PLS also quickly recognized that it was feasible to close the laboratory completely while simultaneously improving lab services provided to the hospital.

At this time, the laboratory had 21 employees. "We proposed a total closure of the laboratory," stated Bob Hamon, Administrative Director of PLS. "We committed to three goals: 1) decrease the laboratory cost of providing services to this site's lab users; 2) maintain or improve turnaround time; and 3) avoid any lay-offs of lab employees.

"Despite these commitments, administration was not totally convinced," he said. "Instead, the decision was made to remodel the laboratory and keep it open. Because it was an older design, with many small rooms, we needed to open the space and create a modern rapid response lab."

Here is where unplanned events often create positive outcomes. "In order to remodel the space, we had to totally shut down the laboratory for four months. Testing was done at the hospital across the street," explained Hamon. "We maintained service levels during the remodel. After remodeling expenditures of $180,000, the laboratory was reopened.

"It remained open for only 90 days! Service on-site was no better than what we had delivered during the time the laboratory was closed, so administration decided to permanently close it," he continued. "This generated annual savings of $325,000."

Hamon's story illustrates a major frustration common to proactive laboratory directors. It is often difficult to get administration and physicians to support a radical change. Yet, radical changes are commonly the source of great improvements in service and reductions in cost. In the case of Presbyterian, it led to an unnecessary remodel of the on-site laboratory.

On the flip side of the coin, Hamon's story illustrates the importance of always doing the best job possible. It was the consistent performance of the laboratory staff to maintain services while the remodel was under way which convinced administration that an off-site laboratory could effectively support that hospital's testing needs.

outreach revenues topped $13 million. This climbed to $18 million in 1996. "As 1996 rolled around, we decided to acquire a small laboratory," Hamon explained. "We also did two other things for the first time. We opened our first patient service center and we began providing laboratory services to our first non-affiliated hospital. These both support our regional growth strategy."

Since then, PLS has recognized the need to expand the core laboratory and develop a more extensive network of patient service centers. Buildout of a new 54,000 square foot off-site core laboratory is under way and expected to be ready in the spring of 1998. Additional patient service centers are opening as marketing studies indicate the need. All of this continues to fuel steady growth. Since 1996, outreach revenues climbed another $4 million, to $22 million.

"We understand that we must be close to our customers if we are to succeed," said Hamon. "One important secret to our success is that we carefully study the needs of our customers, then try and exceed their expectations. Our largest customer is Presbyterian Hospital. Everyone on our laboratory team understands the importance of meeting the customers' needs and expectations, whether it is a hospital customer or an outreach customer."

Hamon probably understates the stress placed upon meeting customer expectations. PLS rigorously tracks a number of performance monitors. "In outreach, we guarantee that stats will be turned around in 45 minutes, 85% of the time. We publish a report that lists our service level. Our average stat turnaround time for the downtown campus hospital is 21 minutes. We meet our stated service level 91% of the time."

Critical Success Factors

The sustained, multi-year growth of Presbyterian Laboratory Services is not accidental. It happened for several reasons.

First, the medical director, Dr. Schwartz, and hospital administration recognized, as early as 1988, that outreach specimens were essential if PLS was to increase testing services and provide Presbyterian with year-to-year decreases in testing costs. Unlike many institutions, at Presbyterian a common commitment by the pathologists, lab management, lab staff and hospital administration was critical in moving PLS forward.

Second, there was early recognition that money would have to be invested if an outreach program was to succeed. Scrapping a four-year old LIS system indicates the serious level of financial support administration was willing to provide the laboratory.

Third, laboratory administration recognized early that full consolidation of the laboratories was essential if the entire laboratory organization was to excel and grow. As early as 1988, laboratory administration advocated consolidation of laboratories at key sites.

Four, leadership in both the hospital and the laboratory were willing to take risks to pursue their growth strategy. This meant major capital dollars invested in an off-site core laboratory, LIS enhancements and to create a professional marketing staff.

Five, PLS was willing to look at successful management models anywhere in and out of healthcare to import the most effective management techniques into the laboratory. PLS actively sought out appropriate "best practices," then imported them into the laboratory. Using the team facilitator consultant is an example of this openness to outside management thinking.

Six, and this is a critical success factor. PLS recognized the importance of a professional sales and marketing program. Accordingly, they invested money to bring aboard a qualified, experienced marketing manager. PLS also insisted that the marketing program achieve production targets, with penalties for failing to achieve those targets.

As a critical success factor, the performance of the marketing department must be recognized. From its initial start in 1992, with outreach revenues of $3.5 million at year's end, PLS will do $22 million in 1997! That is 600% growth in just five years.

All of these successes are due to the team effort, strong leadership and a supportive administration at the parent health system. Our second installment of this two-part series will delve into the management strategies which Presbyterian Laboratory Services hopes to use to remain an effective competitor in the managed care world of the future. TDR

(For further information, contact Bob Hamon at 704-384-5116.)

Managed Care

National HMOs Having Trouble Digesting All Their Acquisitions

HARD TIMES for the clinical laboratory industry have lasted for at least three years. Now it appears that national HMOs may be in for an extended period of financial difficulty.

Earnings reports from major HMO corporations disappointed Wall Street. **Cigna, Aetna** and **PacificCare Health Systems** reported bad financial news in recent months. Operational struggles at **United HealthCare** and **Prudential** are widely known.

Not Good For Lab Industry

These developments may not be good for the clinical laboratory industry. If HMO giants are losing money, it will be tough for these companies to ease the reimbursement squeeze laboratories have endured in recent years.

This is an important issue to the laboratory industry, because it is the declared goal of these companies to develop a national network of healthcare systems. Certainly the impact of the national sole source lab testing contract between Cigna and **SmithKline Beecham Clinical Laboratories** demonstrated that, in certain regional markets, a lot of money was at stake.

Three key problems plague the major HMOs. None will be quickly resolved. First, data integration is now recognized as a critical success factor. Attempts to interconnect various clinical, financial and data storage systems in each region with the national parent are proving to be expensive, time consuming and unsatisfactory.

This has an insidious side effect. Without good information, many of these HMO systems are unable to accurately track costs and establish appropriate prices. Since healthcare premiums are negotiated once a year, it can take an HMO a long time to recover from pricing mistakes.

Second is the increasing complexity of the managed care business. Five years ago, managed care was a simpler business. New forms of competition have emerged and more sophisticated products are hitting regional markets. For example, hospitals and physicians began developing their own managed care products. At the same time, public demand for less restrictive plans and more choice require more complex administration while increasing medical costs. National HMOs must respond to these dynamics in regional markets throughout the country, making it tougher for headquarters to address regional problems in a timely way.

Third, a national company does best when it standardizes its product. Efforts by national managed care companies to standardize are running into firm resistance at the regional level. Cigna Healthcare President H. Edward Hanway summed it up, “You certainly can’t take a McDonald’s approach to healthcare, because it is still very much a local business.”

Uncertain Future For Labs

If the financial difficulties now becoming visible among the national HMOs continue into future years, it will not be good for the clinical laboratory industry. The managed care plans will try and maintain financial health by continuing to cut reimbursement to all providers, including laboratories. Since more reimbursement cuts are still ahead in Medicare and Medicaid programs, it means that clinical laboratories will see little relief on the laboratory reimbursement front in the near future. TDR

The Dark Index

Quest Diagnostics & SmithKline Release Third Quarter Financials

It appears that 1997 will be kinder to **Quest Diagnostics Inc.** and **SmithKline Beecham Clinical Laboratories** (SBCL) than the last three years. Both companies reported improved financial results for third quarter and mixed results for year-to-date.

As of press time, **Laboratory Corporation of America** had not released third quarter earnings. But early indications are that LabCorp will not disclose any surprising financial news.

Throughout the year, THE DARK REPORT highlighted the changing business strategies of the three blood brothers. Third quarter earnings data demonstrate consequences of the different business approaches incorporated by Quest and SmithKline.

Early this year Quest Diagnostics stated that they intended to exert strong pricing discipline and either reprice or walk away from unprofitable business. *(See TDR, June 2, 1997.)* Quest's third quarter revenue declined 7.9% from same quarter last year, indicating they were willing to give up some amount of existing business.

Aggressive Pricing Strategy

SmithKline Beecham Clinical Laboratories pursued an aggressive pricing strategy designed to capture increased market share. Revenues at SBCL increased 9.0% from same quarter last year, as would be expected from SmithKline's strategy of increasing business volume. Comparing how these different pricing strategies impacted profit is difficult, because SmithKline does not provide detailed financial data on the laboratory division. SmithKline did state that operating profit within the laboratory division increased for the quarter by 26%, to $39.0 million.

Quest reported that earnings before interest, taxes, depreciation and amortization (EBITDA) was $35.7 million for third quarter. Comparing the Quest number against SBCL's is not precise, because they don't represent the same accounting definition. But it is interesting to note that SmithKline, on a revenue base of $350 million for the quarter, earned an operating profit of $39.0 million. Quest, with a revenue base of $373.7 million, earned $35.7 million.

Similar Profit Margins

Despite different pricing and business acquisition strategies, the profit margins of both companies are quite similar. This demonstrates that the national marketplace for clinical laboratory services remains highly competitive. Prices continue to be bid to the absolute lowest levels in most regional markets.

Quest Diagnostics chose to comment on some other business statistics which are relevant for gauging the nature of the marketplace. Quest states that its revenue decline came from three basic sources: changes in government and private payer reimbursement policies, intensified competition from

hospital outreach laboratories in several regions, and Quest's strategy of refusing business which does not meet minimum profitibility objectives.

Hospital laboratories considering whether to launch laboratory outreach programs should take careful note of Quest's statement that one source of declining revenues was losing business to hospital outreach programs.

This is validation of THE DARK REPORT's prediction several years ago, and again at the *Executive War College* in New Orleans last May, that the movement towards managed healthcare and integrated delivery systems would give hospital laboratory outreach programs a competitive advantage over the national laboratories.

Phoenix provides a good example of how a well-run laboratory outreach program owned by an integrated healthcare system can gain a strong market position. Quest Diagnostics, after years of struggle to improve the market share and financial performance of its laboratory division in Phoenix, chose to join forces with a local competitor, **Sonora Laboratory Sciences**, owned by **Samaritan Health System**. The joint venture, called **Sonora Quest Laboratories, LLC**, combined both laboratory operations and became operational this summer. *(See TDR, August 4, 1997.)*

Billing Operations

Quest Diagnostics also reported that improvements in billing operations were showing results. Number of days sales outstanding was 67 days at the end of third quarter, compared with 65 days at the end of second quarter. This stands in contrast to LabCorp's woes in the same area earlier this year, when days sales outstanding was as high as 120 days.

Although the third quarter performance by Quest and SBCL was significantly improved over the same quarter last year, financial data for the nine months of 1997 shows mixed results over 1996. SBCL's nine month revenues were only up 2.2% over 1996, from $982 million to $1.004 billion. Operating profit actually declined 1%, going from $94 million in 1996 to $93 million in 1997.

Putting these earnings releases into perspective, third quarter financial performance demonstrates that management strategies at Quest Diagnostics and SBCL are taking root.

Quest Diagnostics saw nine month revenues decline 5.5%, from $1.63 billion in 1996 to $1.23 billion this year. Operating profit is not relevant, as special charges in 1996 related to the divestiture from Corning Incorporated were significant.

Putting these earnings releases into perspective, third quarter financial performance demonstrates that management strategies at Quest Diagnostics and SBCL are taking root. In the last three months, cumulative management efforts are beginning to impact revenues and earnings. The question is whether recent peformance gains can be sustained during the next two years.

Indications are the three blood brothers continue to endure cost cutting initiatives, staffing cutbacks and reduced capital budgets. This means that nimble regional competitors still have the opportunity to outperform the national competitors in their local markets. One such example of a nimble hospital laboratory outreach program is **Presbyterian Laboratory Services**, profiled on pages 9-15 of this issue.

Earnings releases by the public laboratories provide valuable evidence as to how pricing and other business strategies adopted by these laboratories are succeeding in the marketplace. TDR

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

First confirmation that CPT codes for automated cytology are on the way comes from **NeoPath, Inc.** in Redmond, Washington. The company announced that, effective January 1, 1998, CPT code 88152 will cover the procedure involving NeoPath's AutoPap® 300 QC System for Pap smear rescreening.

MORE ON:... CPT CODES

Although other automated cytology CPT codes are expected to soon be available, there are still hurdles to overcome before widespread acceptance of this technology will occur. Currently healthcare payers see this technology as adding cost to the system. That may change as vendors for automated cytology systems continue to educate providers and payers alike. Also, continued usage of these systems in clinical settings will provide evidence as to their effectiveness and value.

ADD TO:... NEOPATH

Reuters recently reported that an investment group including George Soros, the well-known financier, recently bought a $23 million stake in NeoPath and now controls 9.8% of the company's stock.

IS HEALTHCARE A BUSINESS?

One theme of THE DARK REPORT is our belief that laboratories, indeed all healthcare providers, must acquire business savvy to survive the managed care evolution. Evidently that concept is still foreign to the **American Medical Association**. *Crain's Chicago Business* published an item worth passing along: *Business celebrity does have its limits: ...despite all the self-promotion by **Sunbeam Corp.** Chairman Al Dunlap as a company-saving job-slasher, the Chicago-based American Medical Association took little note of "Chainsaw Al" before its recent ill-fated deal to endorse Sunbeam products. "I wouldn't have recognized him, quite frankly," concedes AMA Chairman Thomas Reardon, an Oregon physician. "I'm not in the business world."* (our emphasis.)

MORE ON:... BUSINESS

What is particularly ironic about Dr. Reardon's comment is that his association had just signed, then voided, a major business deal for the AMA to endorse Sunbeam products in exchange for a share of the profits. Now Sunbeam is suing the AMA for $20 million in damages for backing out of the deal.

Early registrations for *THE DARK REPORT'S Pathology Income Symposium & Workshop* indicate that a strong group of business-minded pathologists will be in attendance. Scheduled for November 8 in Scottsdale, the program is focused entirely on the subject of pathology compensation. For details, call 800-560-6363.

HEARD ON THE STREET:

Two East Coast laboratories raided the West Coast for talent. Recently **Dynacare** hooked Rob Alpert from San Diego to run its Albany, New York venture. **American Medical Laboratories** in Chantilly, Virginia persuaded Los Angeles-based Vicki Di Francesca to join its sales and marketing team. Is this a comment on how valuable the market considers lab executives who've gained experience in California's managed care crucible?

That's all the insider intelligence for this report.
Look for the next briefing on Monday, November 17, 1997

THE DARK REPORT

UPCOMING...

- Part Two: Presbyterian Laboratory Services Evolves Toward Regional Laboratory Resource.
- Third Quarter Earnings For Smaller Public Laboratories Reveals Surprising Successes.
- Hospital Purchasing Alliances Developing New Strategies For Vender Contracts.
- Dynacare To Acquire Louisiana Reference Laboratories.