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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

Consolidation Within the Auto Industry

As our system of healthcare evolves in this country, I am continually amazed at how many market dynamics we share with other industries. Take the issue of too many hospital beds and too much laboratory capacity. With inpatient utilization declining, with laboratory reimbursement shrinking, both hospitals and laboratories are forced to: (1) find more patients; (2) shut themselves down; or (3) join up with other providers in the region to consolidate business resources in an economical manner.

In a nutshell, both hospitals and laboratories are in a consolidation phase. The number of hospital acquisitions, mergers, joint ventures, affiliations and alliances has reached record levels during each of the past three years. As individual hospitals come under common management, consolidation of laboratory services occurs sooner or later.

So it was with some interest that I read a recent *Wall Street Journal* story about consolidation of automobile dealerships. Yes, dear reader, the auto industry is going through a parallel process of consolidation similar to hospitals and laboratories. Market circumstances are almost identical!

Demand for new cars is flattening. New competitors (from Japan, Korea and Europe) have diminished market shares of the three Detroit automakers. Expenses of operating a dealership have increased faster than revenues. Thus, the auto industry is saddled with more dealerships than necessary. Already, several auto dealers are buying up individual dealerships and putting them under a common management umbrella (market consolidation). Now, both **Ford** and **General Motors** actively seek to consolidate dealerships in specific cities (intracompany consolidation). Ford will experiment with this new model in Tulsa and San Diego.

General Motors plans to buy 11 underperforming dealerships in California's San Fernando Valley. These will be combined into four or five dealership locations, located in prime retail locations. The dealerships will pool inventories and spare parts, reducing costs. By sharing inventories of parts and cars, advertising jointly, and using a single body shop and management team for all dealerships, GM "hopes to save millions."

I see parallels to our laboratory consolidation projects. In the San Fernando Valley, GM will operate a "core lab" (inventories of parts and cars, plus auto body shop) and stat labs (the four retail dealerships) under common management. Because of similar market problems in both industries, I wouldn't be surprised if some management strategies used in consolidating auto dealerships might not be equally effective in consolidating laboratories. TDR

"State of Lab Industry" Reveals Radical Change

Throughout 1998, expect continued pressure to restructure and reengineer lab operations

CEO SUMMARY: Pick your trend: declining reimbursement, consolidation, clinical integration, downsizing, and capitated reimbursement. These trends all continued to shape the way laboratories organized to provide services. But 1997's wildcard was the federal government. Between investigations and new regulations, laboratories were hit hard.

FOR THE clinical laboratory industry, 1997's biggest surprise was both unexpected and unpleasant: stifling government intrusion into laboratory operations and business practices.

Whether deserved or not, during 1997, clinical laboratories became the whipping boy of government regulators. Healthcare regulators and federal prosecutors found castigating laboratory billing practices was a good way to earn points with Congress and the American public. Three important outcomes emerged from this process.

First, government regulators were encouraged to expand their investigation of laboratory billing practices to include hospital laboratories and smaller commercial laboratories throughout the country.

Second, to close existing "loopholes" and prevent further abuses of federal healthcare programs, HCFA decided to tightly regulate the laboratory industry.

Third, after successfully extracting almost $1 billion in Medicare fraud and abuse settlements from clinical laboratories, government investigators found motivation to search out fraud elsewhere in healthcare. Now hospitals, home healthcare agencies and long term care facilities are undergoing the same investigative scrutiny as was formerly directed only at the laboratory industry.

Against this backdrop of intensified government involvement in clinical laboratory operations, it can be said that the "state of the laboratory industry" is troubled. The government is only one important dynamic acting upon the laboratory industry at this time. Other dynamics impacting the laboratory marketplace have equal potential to radically alter the organization and

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operation of clinical laboratories as we know them today.

In this exclusive "state of the industry" analysis, THE DARK REPORT identifies seven key areas of sweeping change. During 1998, it will be essential for laboratory organizations to develop a management strategy in response to each of the seven trends.

Separate Paradigms

What is important to understand is that each key area represents a separate paradigm. Taken collectively, these seven paradigms are shifting simultaneously. At no time in the history of the laboratory industry has change come in such a diffuse and widespread manner.

Consider the range of key trends identified in this article. Some of these trends directly alter the organization of laboratories. Consolidation, regionalization, and clinical integration are processes which restructure and reengineer existing laboratory business models.

In contrast, government regulations create arbitrary responses which may require laboratories to handle testing and billing in burdensome ways. Declining reimbursement levels and alterations to payers' reimbursement procedures similarly impact the organization and delivery of laboratory services.

THE DARK REPORT predicts that laboratory executives will find one particular trend to be most challenging at a personal level. The coming revolution in management philosophy will force laboratory managers and administrators to develop new skills.

This new management philosophy places a strong emphasis on managing people and processes, with a focus on meeting and exceeding customer expectations. It will supplant and eventually replace the old "top-down" authority structure which business borrowed from the military.

Instead of a hierarchical chain of command, this new management philosophy will require laboratorians to become leaders of people. Formerly, most laboratory administrators could succeed simply by maintaining the stability of the laboratory's technical processes. For this reason, the impending paradigm shift in management philosophy will be difficult for many "old guard" laboratory managers to accept and embrace.

Because there is a simultaneous shift of seven different paradigms, laboratory executives are faced with unprecedented challenges in how their laboratories are organized and managed. The coming years will bring accelerated change in multiple dimensions. This accelerated change will be accompanied by sustained levels of high stress.

Whether these seven elements are labeled as "market dynamics" or "marketplace trends" matters little. We recommend that you convene your management team and discuss how each of these seven elements may interact upon your laboratory organization during the next five years. Use these discussions to cue strategic thinking within your laboratory organization.

Seven Paradigm Shifts

As these seven paradigm shifts interact upon the laboratory industry, there will be winners and losers. Based on extensive site visits to laboratories throughout the United States, THE DARK REPORT identifies two basic qualities which separate winning labs from their peers. First, winning laboratories have a leader capable of motivating people and nurturing change in a proactive, innovative way. Second, winning laboratories have an accurate strategic picture of their marketplace. They understand the importance of evolving "ahead of the change curve" if they are to remain viable and competitive.

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

State of the Laboratory Industry-Key Trend #1

Clinical Integration

CLINICAL INTEGRATION of healthcare services is evolving at a steady pace. At some undetermined point in the future, it will become the dominant organizational model for healthcare.

During 1998, most laboratory organizations will see this trend as neither fast-moving nor threatening. After all, clinical integration is currently more of a concept than a reality.

One important premise to managed healthcare that sets it apart from the previous fee-for-service system is the goal of providing a continuum of care for an individual.

Fee-for-service was good at providing episodic and acute care. But fee-for-service frequently failed to achieve two worthwhile objectives: 1) providing continuity of care to an individual; 2) practicing preventive healthcare.

Managed care is partially a market response to the failure of fee-for-service to provide either of these two benefits. However, in order for managed care plans to provide total "cradle to grave" healthcare in an effective manner, they must create a clinically integrated healthcare network.

Integrated delivery systems are forming in cities throughout the United States. As hospital labs find themselves merged into a healthcare system, consolidation is one of the first organizational changes to occur. For commercial labs, the formation of an integrated delivery system may mean that they see a shrinkage of business. As physician practices are acquired by the emerging system, commercial labs are excluded from providing testing services. The integrated delivery system gives preference to its internal laboratory organization.

Given the fact that most of these integrated delivery systems (IDN) are in early stages of organization, their capabilities are limited. Currently neither integrated delivery systems nor managed care plans have yet to organize a true, clinically integrated healthcare service.

One impediment to clinical integration is the lack of effective information systems. Current IS technology inhibits effective clinical integration. Another impediment involves provider attitudes. Physicians and other providers still want independence to practice medicine as they see fit.

Both these impediments will be overcome with time. Clinical integration will occur because it is a rational, economic and effective way to deliver high quality healthcare services.

Laboratories will be required to play a different role within a clinically integrated healthcare system. Business practices and organizational models that were acceptable in the old fee-for-service world will prove inappropriate.

For laboratories, it is critical to understand why clinical integration will occur. Laboratory executives should begin to position their laboratories to provide the type of services which add value to an integrated healthcare organization. There is a window of opportunity to develop such services ahead of competitors.

State of the Laboratory Industry-Key Trend #2

Consolidation

PROBABLY THE MOST VISIBLE trend in 1998 will be consolidation of hospital-based laboratories. This is a direct result of the phenomenal number of hospital mergers, acquisitions, alliances and joint ventures which occurred during the previous three years.

Economics drives laboratory consolidation. High volume laboratories can perform tests more cheaply than low volume laboratories. Hospital administrators, under pressure to reduce costs wherever possible, quickly recognize the benefits of consolidating laboratories. Compared to other clinical services, laboratory consolidation is relatively easy to accomplish. Fewer political issues are involved, and it does not require moving patients between facilities.

Since 1995, laboratory consolidation has moved from being an exceptional event to a common industry activity. This trend will continue for several more years.

There is a two-fold impact upon the laboratory industry. First, most savings in hospital laboratory consolidation come from staff cutbacks and layoffs. This reduces the number of available jobs for med techs and laboratory managers. It also reduces the demand for med techs in the cities where laboratory consolidation occurs.

Second, laboratory administrators who remain in charge of the consolidated laboratory face a new challenge: managing multiple laboratory sites. It requires a different set of skills to provide leadership and management across two or more geographical locations. Most laboratory administrators have only been required to manage a single site laboratory. When selected to manage a multi-site consolidated laboratory operation, they must acquire the necessary leadership skills to be effective at this new position.

The consolidation wave which engulfed commercial laboratories ended in 1995. Now hospital laboratories are undergoing a similar wave of consolidation. As this trend works its way through the marketplace, it is beginning to transform the laboratory industry in fundamental ways.

Consolidation removes excess or unused laboratory capacity from the marketplace. But it also creates a new type of laboratory provider, with regional capabilities. In so doing, the consolidation trend creates new opportunities for partnering. Commercial laboratories recognize this. They maintain extensive sales and marketing programs to promote partnering arrangements with hospital laboratories.

Because a consolidated laboratory represents a different class of buyer for instruments, reagents and other laboratory supplies, there will be changes in the way vendors package their products and contract for services. Additionally, hospital laboratory consolidation encourages consolidation among vendors. Expect to see more mergers similar to that of **Beckman and Coulter.**

Consolidation of hospital laboratories is the necessary precursor to full-blown laboratory regionalization. It is already one of the most influential trends of the 1990s.

State of the Laboratory Industry-Key Trend #3

Regionalization

EARLY ATTEMPTS TO CREATE regional laboratory networks were not overwhelmingly successful. Yet the future of the laboratory industry lies in regionalizing services.

Early successes of Pittsburgh's **Reference Laboratory Alliance** and San Francisco's **Bay Area Hospital Network** were widely reported during 1995 and 1996. Their example caused regional laboratory networks to sprout in a variety of cities and states.

But it is no coincidence that the regional laboratory network movement disappeared from center stage. Political, economic, and management difficulties of organizing such networks are daunting. The process of creating a *viable* regional laboratory network is proving more difficult than organizers imagined.

THE DARK REPORT predicts that regionalized laboratory service organizations will eventually be seen as the single most important business model to emerge during the 1990s. Despite the high profile of regional laboratory networks, we believe the successful business models of regionalization will emerge from the consolidated laboratory organizations now operational in several cities.

Further, commercial laboratories continue to push development of regional laboratory models. It is an essential strategy for them, since integrated delivery systems tend to exclude them by definition.

Regional laboratory systems will emerge because managed care is squeezing excess capacity out of existence. It is widely recognized that we have too many hospital beds in the United States. It is also true that we have too much laboratory capacity.

THE DARK REPORT believes that regionalization will be the method used in local markets by existing laboratory providers to better align existing laboratory resources with the local demand for laboratory testing and services.

That is the reason we believe regional laboratory organizations will emerge from the 1990s as the predominant business model. A properly-designed regional laboratory system eliminates excess capacity and wasteful duplication. It can provide services and access points across the same geography covered by managed care plans in that metropolitan area.

One intrinsic strength of the successful regional laboratory provider is that it will not build "new" laboratory capacity. Rather, the regional laboratory organization will incorporate existing laboratory assets into the delivery system.

That is why we predict these regional organizations will be a consortium comprised of hospital laboratories, commercial laboratories with facilities in the region, specialty laboratories and even physician office laboratories. Early evidence from the marketplace leads us to predict that these regional consortia will evolve from consolidated laboratory organizations, not regional laboratory networks.

State of the Laboratory Industry-Key Trend #4

Reimbursement

DURING THE COURSE OF 1998 and beyond, adequate reimbursement is the critical success factor for laboratory survival.

Reimbursement is listed as a separate trend from government regulation because it is a distinctly different market dynamic. Reimbursement relates to all the sources of money flowing into the laboratory.

THE DARK REPORT sees two critical aspects to reimbursement. One aspect involves the actual reimbursement schedules posted by managed care plans and government healthcare programs. The other aspect deals with the contractual form of reimbursement, such as fee-for-service versus prospective payment.

In terms of actual reimbursement schedules, it is no mystery that reimbursement for laboratory services declined steadily in recent years. This decline will continue into the foreseeable future. To respond, laboratory managers must develop business plans which allow the laboratory to synchronize cost reduction efforts with expected reimbursement declines.

However, the more insidious impact on the management of laboratories will be prospective payment arrangements, such as capitation. The majority of laboratory managers do not yet comprehend how capitation revolutionizes the management of laboratory operations.

When reimbursement was based on fee-for-service, laboratory managers were required to keep expenses in line with expected revenues. Sustaining test volumes above the break-even level was probably the easiest way to maintain a financially viable laboratory. This was a relatively straightforward process. In fact, the generous reimbursement fee schedules of that era almost guaranteed that any laboratory could make adequate profits. Thus, most managers focused on technical challenges, such as maintaining testing at a high quality and with a consistent level of reproducibility.

Now comes the era of prospective payment, centering around capitation arrangements. This transforms the way a laboratory must be managed. Payment for testing is fixed, against an uncertain range (possibly even uncapped) of expected utilization.

Prospective fixed reimburesment means managers must operate the laboratory differently. Management now needs to get accurate cost data, utilization information and productivity measurements on a timely basis. Management must use this data to keep laboratory expenses in line with the prospective reimbursement.

If utilization climbs beyond expected levels, management must learn this fact as soon as possible, because it is essential to respond by both cutting costs and learning why utilization rates jumped upwards.

The net impact of prospective payment is that it greatly complicates the management requirements for financial stability. It means that laboratory executives must closely scrutinize variables which previously were received little attention or priority.

State of the Laboratory Industry-Key Trend #5

Government Regulation

MORE APTLY DESCRIBED as government intervention than regulation, this is one area which will receive the most time and attention by laboratory management throughout the upcoming year.

After analyzing the government's influence on healthcare in general and laboratories in particular, THE DARK REPORT believes that government intervention will increase during the next few years. If true, this is a critical point.

It is our opinion that government regulation will take the form of micro-management. From this point forward, expect to see an unending cascade of guidelines for clinical practices and regulations concerning reimbursement procedures.

Within the laboratory segment, the four organ panels represent the first tangible sign of this heightened government involvement in healthcare. The organ panels are less about preventing Medicare fraud and abuse and more about constraining test utilization. Expect to see a steady stream of directives and guidelines concerning clinical practices.

Although the requirement that all laboratories implement a compliance program is attracting most of the headlines, we think it is important that laboratory executives understand that the real battleground between healthcare providers and government healthcare regulators will center upon regulation of clinical practices.

Because the clinical laboratory industry was the first healthcare segment to become tainted with Medicare fraud, it will be the most visible target of new directives.

The financial impact of these clinical practice directives will be significant. But it will be difficult to oppose them on the basis of how they affect reimbursement, since the government issued them to "improve clinical practices," not to affect reimbursement.

Therein lies the reason why regulators will focus less on reimbursement guidelines and more on clinical practice directives. They can lessen utilization, reducing the dollars paid out for these procedures, without having to cut the designated reimbursement for the procedures. This avoids political debate on reimbursement levels.

Another crucial point relates to government micro-management of healthcare. This involves private payers such as **Blue Cross**, **Aetna/US Healthcare**, **Cigna**, **Prudential** and others. Increasingly, these private payers are adopting HCFA's guidelines and directives as their own.

Thus, another result of increased government intrusion into healthcare is to spread the government's complicated, contradictory and obtuse regulations into the private sector. For the laboratory industry, it represents a double dose of very bitter medicine.

During the next two or three years, government involvement in the day-to-day management of healthcare will increase. Clinical laboratories should understand the subtle philosophical changes now altering the way their activities are regulated.

State of the Laboratory Industry-Key Trend #6

Technology

TO REMAIN A VIABLE PROVIDER, laboratories must quickly evaluate new technology and introduce worthwhile offerings into the clinical marketplace ahead of the competition.

New technology has the potential to improve the competitive position of laboratories. But it will also influence and change the organization and operation of laboratories. A variety of innovations and discoveries will drive these changes.

Automated cytology systems represent a good example of how new technology can potentially transform the laboratory. The first generation of automated cytology systems is currently entering the marketplace. As this technology proves its clinical value, there will be radical changes to the way Pap smears are prepared and evaluated.

Potentially, monolayer technology could become the gold standard for preparing Pap smears. On the diagnostic side, subsequent generations of automated cytology instruments could replace cytotechnologists completely.

Assume, for a moment, that both technologies achieve this potential. To incorporate this technology, clinical laboratories need to organize themselves differently. There is a precedent where radical technology shifts affected a large segment of laboratory specialists. Remember hemotechs? They became extinct with the arrival of automated hematology machines.

Because of the potential for new technology to transform laboratory operations, THE DARK REPORT regularly covers new developments in the field. If most laboratory administrators fully understood the vast amount of tangible research which will soon be introduced into clinical practice, they might well decide to pursue a career outside the lab industry.

Laboratory automation technology is directed towards combining related instruments into automated modular clusters. Miniaturization of test instruments is creating a new class of smaller instruments which can be used for point-of-care and near-patient testing. Micro-miniaturization technology, combined with electronic chip technology, is striving to create silicon micro-chips which use microscopic amounts of bio-sample and reagent to perform the test on the chip itself, at a cost of pennies per procedure.

Genetic research is leading directly to the development of diagnostic assays which are not phenotypic-based, but are genetic-based. The explosion of PCR testing demonstrates how quickly this technology can find extensive clinical application.

Competition will force laboratories to stay abreast of this technology explosion. As clinical efficacy is demonstrated, early innovators will be rewarded by the marketplace. This is one reason why the three national labs quickly acquired automated cytology systems when they earned FDA approval two years ago.

In order to maintain a cost and service advantage over their competitors, all laboratory organizations will need to introduce innovative technology as early as possible. Because the pace of change and speed of introduction for new technology is accelerating, laggards may well find themselves locked out of the game.

State of the Laboratory Industry-Key Trend #7

Management Philosophy

HERE IS THE ONE AREA of clinical laboratory operations which gets short shrift. Management philosophy and style underpins the success of any service organization in the world.

The entire healthcare industry starts with a handicap. During the fee-for-service days of the 1980s, business management was not a critical success factor in the financial performance of any healthcare provider. It was easy to "make money" as long as a provider could keep expenses aligned with generous fee-for-service reimbursement schedules willingly paid by private payers. Even Medicare/Medicaid reimbursement levels where considered acceptable in those days.

Most healthcare providers were organized as the traditional hierarchy. It was management from the top down. With everyone doing well financially, there was little incentive to change the management style of healthcare organizations.

Meanwhile, in the real world of business, management was undergoing a revolution. Japanese car manufacturers invaded the United States and captured huge market share. (Remember **Chrysler's** near-bankruptcy?) Japanese televisions and electronic goods swept American products off the shelves. Japanese mini-mills dominated the steel industry.

To survive, American businesses were forced to change the way they were organized and managed. W. Edward Deming, Joseph Juran, Philip Crosby and Tom Peters expounded new ways of managing people and producing products and services.

Keystones to this philosophy are an emphasis on meeting customer needs, a focus on "process design" to produce products and services free of errors, and empowering employees to respond with their own knowledge and initiative.

While American business was undergoing this transformation, healthcare continued in its isolated world. Then came the arrival of managed care, accompanied by declining reimbursement, which eroded the financial security of hospitals, physicians, laboratories and other categories of providers.

Nowadays, sustained success for any healthcare organization, including clinical laboratories, will only come from effective implementation of the new management philosophies which have achieved worldwide validation and acceptance.

One can debate the merits of TQM (total quality management), CQI (continuous quality improvement), reengineering, ISO-9000 and other various acronyms for management paradigms. But one cannot deny that these represent a new philosophy of management which will not disappear.

The new generation of executive leaders in the clinical laboratory industry will be those managers and administrators who understand this fact, and develop the knowledge and expertise to manage people using these new philosophies.

For better or worse, the former way of organizing and managing a laboratory is no longer viable. The future belongs to those individuals willing to incorporate the new management philosophies into their personal style.

Quest Announces Major Restructuring for 1998

Changes will include staffing reductions, downsizing of several regional laboratories

CEO SUMMARY: Recognizing the reality of laboratory overcapacity in the marketplace, Quest Diagnostics Incorporated intends to align its laboratory capacity with existing specimen volumes. In so doing, it's taking a progressive step and moving more aggressively than its two national competitors to resolve an issue which impacts the entire industry.

WHEN IT WAS ANNOUNCED last week that **Quest Diagnostics Incorporated** would downsize several regional testing centers, the prime motivation was to reduce laboratory overcapacity and improve corporate cash flow.

In a press release dated December 2, Quest Diagnostics noted that laboratories in Atlanta and Tampa were scheduled to be converted into "Local Customer Centers with rapid-turnaround (STAT) laboratories for time-sensitive testing." Quest also declared that the St. Louis regional laboratory would be reduced in size, along with several smaller branch laboratories in various regions of the country.

Quest Diagnostics estimated that its work force will shrink by approximately 1,000. This is a 6% reduction in the company's overall employment. The restructuring will take place during the course of 1998.

In taking these actions, Quest Diagnostics is once again demonstrating initiative relative to its national competitors. There is excess laboratory capacity in most cities. Laboratories which figure out a strategy to downsize capacity while improving profit margins should gain a competitive edge over other laboratories in that specific market.

But Quest's actions also provide insight into the difficulties of sustaining a geographically diverse system of laboratories. Both **SmithKline Beecham Clinical Laboratories** and **Laboratory Corp. of America** face the same pressure. Announcements about restructuring and reengineering of their national laboratory systems should be expected during the next 24 months.

> ***"Given the overcapacity that characterizes our industry, reduc- ing the size of these facilities was a difficult but necessary decision."***
>
> ***—Kenneth W. Freeman***
>
> *Chairman & CEO, Quest Diagnostics*

For Quest, these changes will result in a pre-tax charge to earnings, estimated between $60 and $70 million. The company intends to take the charge during the fourth quarter of 1997. In writing off these expenses during fiscal

1997, Quest Diagnostics hopes the earnings improvement resulting from the laboratory restructuring program will improve operating profits and earnings starting in 1998. In fact, Quest Diagnostics estimates that it will take all of 1998 to restructure the laboratories as planned. When completed, the announced changes are projected to generate annual benefits of $20 million.

If true, then Quest Diagnostics is taking an immediate financial charge of up to $70 million, to obtain a projected gain of $20 million per year from the restructuring. With shareholder equity of $566 million and debt of $600 million, Quest has the capability to sustain the write-down.

Quest's Rating Affirmed

Standard & Poor's (S&P) agrees. It affirmed its current rating for Quest Diagnostics, noting a negligible after-tax impact of the charge and a modest increase in financial leverage, from 55% to 58%. But Standard & Poor's also noted the difficult environment for Quest. In giving Quest a "stable" outlook, S&P stated, "In an era of tight-fisted payers, the company [Quest] is unlikely to improve profit margins and credit measures beyond that anticipated by the rating."

S&P recognizes the financial challenges facing all clinical laboratories. Taken in this context, Quest's actions reveal some interesting aspects to the competitive marketplace. Since Quest was able to recast its balance sheet during the spin-off from **Corning Incorporated** last January, it has flexibility to restructure operations.

Obviously, it is not cheap to shut down laboratories, provide severance packages to laid-off employees, and liquidate instruments, equipment and other assets. Quest estimates a $70 million charge, related primarily to three laboratory sites. But the numbers involved in Quest's restructuring illustrate why the national laboratories are not more aggressive at shutting down redundant laboratories in their systems. Note that a $70 million charge generates annual benefits of $20 million. Quest will not recoup this money until mid-year, 2002.

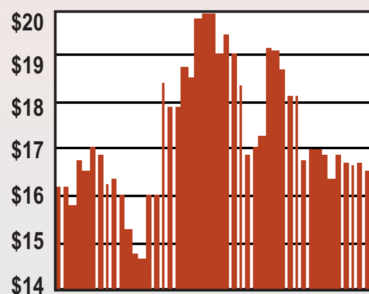
Write-Down Size

The size of the write-down and lengthy repayment period illustrate two points overlooked by most laboratory executives. First, it is very expensive to close a laboratory operation and remove those operational assets from the books.

Second, corporate officers at these laboratories face the constraints of debt-to-equity covenants, along with the need to maintain good relations with lenders, investors and the corporate parent. Even if the right thing to do was to close down underutilized and marginally profitable laboratories, the size of the charge against earnings would trigger a variety of potentially unpleasant events. Not the least of which could be the replacement

Quest's Stock Price Remains Constant

DESPITE THE ANNOUNCEMENT of the $70 million restructuring charge, share prices for Quest Diagnostics Incorporated remained stable. It is a sign that the investment community continues to support the company's business plan.



of existing corporate officers with new Presidents, COOs, CFOs, etc.

However, by allowing marginal laboratories to continue operating, the status quo can be maintained and future developments might improve the situation, offering new options for resolving these problems. This is a strategy of "sit and wait; we'll see what happens."

Commendable Qualities

Seen from this perspective, Quest Diagnostics demonstrates two commendable qualities. First, it is restructuring its laboratory system while it still has the financial capability to accomplish the task. This improves its long-term prospects, particularly if profitability in the clinical laboratory marketplace continues to decline.

Second, its executives were courageous enough to "bite the bullet" and restructure laboratories before market pressures forced them to do so. By taking the initiative, they are actually improving the financial stability of the company for stockholders and the remaining employees.

How will this imminent restructuring at Quest Diagnostics reshape the laboratory marketplace? In any city where Quest ceases local testing and sends the work to a regional laboratory outside the area, there will be an increase in lost clients. It is a given in the laboratory industry that physician office clients do not like change. When a laboratory alters any aspect of service, some clients will switch to competing laboratories.

Thus, in the affected cities, both hospital laboratory outreach programs and commercial laboratory competitors can be expected to intensify their marketing efforts to Quest clients.

Among the three blood brothers, Quest's actions probably give it a long-term competitive edge. Improvement in cash flow helps strengthen the company's ability to compete for new business. By restructuring its own laboratory system, Quest creates pressure on the other two national laboratories to do the same.

This is probably most true of LabCorp. Observers still recognize that redundancies remain from the merger of the two laboratory systems operated by **Roche** and **National Health Laboratories** almost three years ago.

But if Quest Diagnostics must charge off $70 million to restructure three laboratory sites, how large a write-down would LabCorp incur if it closed and wrote off unnecessary or marginally profitable laboratories in its system? Also, would LabCorp's existing balance sheet and debt covenants even permit it to take such a step?

As a market thermometer, the restructuring soon to take place at Quest Diagnostics provides useful intelligence. It is a reminder that all three of the national laboratories continue to deal from a position of relative weakness. They no longer dominate their local markets as they once did in the first half of the 1990s.

Evidence Of Pressure

It is also fresh evidence that intense management pressures continue within the three national laboratory systems. This pressure has been literally non-stop during the past three years. It would be reasonable to expect the burn-out factor to kick-in and show itself within all three companies, particularly with middle managers and sales representatives at the regional laboratories.

Laboratory competitors should also recognize another obvious conclusion. As the three national laboratories focus internally to regain financial stability, there exists an exceptional market opportunity. Hospital-based laboratories which professionally market a competitive laboratory outreach program have an open door to build their client base at the expense of the three blood brothers. TDR

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

Physician Solutions Gets Venture Capital Funding

Private equity commitment totals $18 million; money will fund pathology practice acquisitions

CEO SUMMARY: Physician Solutions becomes the second pathology-based physician practice management company to receive venture capital funding. The company is poised to acquire a number of pathology practices in cities throughout the United States. It is another sign that traditional pathology business models are about to undergo fundamental change.

FRESH ON THE HEELS of an $18 million funding commitment, **Physician Solutions** is ready to commence acquiring pathology practices in various cities throughout the United States.

"News of our funding has triggered acquisition discussions with a number of pathology practices," stated Harold Roe, Chief Executive Officer of the Nashville-based company. "It is reasonable to predict that we will complete four to five acquisitions by the end of January."

Physician Solutions is a pathology-based physician practice management company (PPM). The company's objective is to acquire an equity interest in pathology practices, then help them increase revenue and operating profits.

Philosophy Is The Key

"Our philosophy is the key to understanding our business plan," said Roe. "We see ourselves as partners with the pathologist in a long-term relationship. The common objective of both partners should be to provide superior anatomic pathology services.

"As partners, it is the pathologist who possesses the essential clinical skills. From a financial standpoint, they hold the majority interest in the partnership's cash flow. We play a supporting role. Our minority interest in the partnership allows us to share in the growth of the business.

Incremental Skills

"We provide incremental skills and capabilities which add value to the pathologist's effort," he continued, "Our role in the relationship is to improve the business operations of the practice, provide strategic direction, and market the practice in such a way as to generate profitable growth."

Not every pathology practice is a good prospect for partnering with Physician Solutions. Roe explained why. "We look for pathology practices which meet three criteria.

"First, we would prefer that the pathology practice does not own its histology laboratory. It is our intent to acquire that histology laboratory and use it as a foundation to expand both net revenue and pathology services.

"Second, we seek out pathology practices with a traditional focus on hospital inpatient business. Since they're not doing outreach business, we can

increase and diversify the flow of anatomic specimens by marketing to the outreach community.

"Third, we prefer to partner with pathology practices which are in geographical areas where pathology consolidation has yet to take place. The ability to combine two or more pathology practices is one way to lower overhead and increase operating profits."

This prospect profile is not like the type of pathology practices acquired by **AmeriPath, Inc.**, the first pathology PPM. "The business objectives of both companies are different," explained Roe. "AmeriPath acquired high-volume dermatopathology practices. They've also pursued the larger pathology practices which serve multiple hospitals. These practices handle a considerable volume of specimens. Within their market area, they hold a large share of business and can be considered mature.

"In contrast, we are looking for growth opportunities," he continued. "We want to partner with pathology practices that can be considered at an early stage in market share development. Over five years, it is much easier to double the volume of a two-man practice than it is to double the volume of a 25-man practice."

Employment Versus Equity

Another relevant difference between Physician Solutions and AmeriPath is the relationship between the company and the pathologists. AmeriPath is organized around the employment model. Physician Solutions uses the equity model.

AmeriPath's employee model calls for the company to acquire 100% ownership and control of a pathology practice. The selling pathologists are typically paid five to seven times revenues for their ownership interest.

Funding Sources Lend Credibility

PHYSICIAN SOLUTIONS' $18 MILLION funding commitment immediately makes the company a serious player in the pathology practice management arena. Further credibility comes from the two venture capital firms which invested in Physician Solutions.

The Sprout Group is a venture capital affiliate of **Donaldson, Lufkin, Jenrette**, the Wall Street brokerage house. **21st Century Health Ventures** is an affiliate of **HEALTHSOUTH Corporation**. The participation of The Sprout Group is particularly relevant, as it means that Donald, Lufkin, Jenrette (DLJ) has been involved in both pathology-based physician practice management companies which obtained venture capital financing.

AmeriPath, Inc., of Riviera Beach, Florida, was funded by venture capitalists in 1995 and 1996. In October of this year AmeriPath took its stock public in an initial public offering (IPO). Donaldson, Lufkin, Jenrette was the lead underwriter in AmeriPath's IPO.

21st Century Health Ventures may represent an interesting twist to the Physician Solutions story. Its affiliate, HEALTHSOUTH, owns the largest number of surgicenters in the United States. Surgicenters are a fast-growing source of anatomic pathology specimens. Since these specimens originate outside of the hospital, competition for this AP business will be intense.

Could it be that HEALTHSOUTH is investing in Physician Solutions with the motive that Physician Solutions could eventually become the exclusive provider of anatomic pathology services to HEALTHSOUTH's surgicenters? Were this to prove true, then Physician Solutions could be entering the marketplace with a competitive edge that is unnoticed by others.

They sign an employment agreement and receive a salary from AmeriPath.

Physician Solutions' equity model leaves the pathologists with majority ownership. Physician Solutions invests in pathology practices to acquire a minority interest. Roe explains: "Typically our investment would take the form of purchasing the assets of a pathology practice. We will establish a Physician Solutions subsidiary in that city. Assets would be transferred to that subsidiary. The pathologists retain their professional corporation or partnership arrangement.

"All non-pathologist employees of the practice would also be transferred to the subsidiary," said Roe, "and the subsidiary conducts all business operations. The acquisition agreement specifies a percentage of profit which goes to Physician Solutions for a management fee. The balance of the profits are distributed to the pathologists."

Under this arrangement, the pathologists continue to practice autonomously as before. Physician Solutions assumes responsibilities for management, administration and marketing. As the partnership increases specimen volume and operating margins, then all partners share the increased profits.

Execution Is The Challenge

Now that Physician Solutions has access to $18 million to fund pathology practice acquisitions, the challenge comes in execution. Rapid changes to healthcare and reimbursement will require skillful responses. Another challenge common to Physician Solutions and all PPMs is the ability to strike a balance between acquisitions and operations.

As the second pathology-based physician practice management firm to receive substantial funding from venture capitalists, Physician Solutions is proof to pathologists that a market evolution is under way. Investors are betting huge sums of money that the business models represented by Physician Solutions and AmeriPath will capture business from traditional pathology practices.

Stated bluntly, every dollar invested in a pathology-based PPM is a bet by an investor that these PPM companies can capture significant business from existing pathology relationships. THE DARK REPORT predicts these companies will definitely influence and shape the next generation of pathology business models to emerge from the managed care battleground.

Radical Restructuring

Commercial laboratories were the first to undergo radical restructuring by the marketplace. Widespread consolidation of hospital laboratories is transforming that segment of the industry. Now market forces are concentrating on pathology. These are the earliest stages to a period of change which THE DARK REPORT predicts will be revolutionary, not evolutionary.

During this period of marketplace restructuring, pathologists will need to complement their clinical skills with improved business knowledge. It will become increasingly difficult for pathology practices to sustain profitability if they don't acquire expertise and resources in sophisticated techniques of business management and administration.

Growth of the entire physician management company industry is built upon the recognition by an increasing number of physicians that survival in the managed healthcare world requires a marriage of clinical skills with business acumen. The arrival of pathology-based PPMs comes after PPMS were developed for other medical specialties.

As the next year unfolds, at least two additional pathology PPM models will emerge. Collectively, these business initiatives will influence and reshape how pathology services are organized and delivered. TDR

(For further information, contact Harold Roe at 615-370-5370.)

Lab Industry Briefs

UROCOR, INC. MATCHES THERAPEUTICS WITH DIAGNOSTICS

With the recent signing of a co-promotion agreement with **Zeneca Pharmaceuticals**, **UroCor, Inc.** is positioned to offer therapeutics as a complement to its diagnostic testing.

Based in Oklahoma City, UroCor is a fast-growing company which offers diagnostic testing and disease management services to urologists throughout the United States. Profiled in an earlier issue of THE DARK REPORT, UroCor represents a unique business model for the future of clinical laboratories. *(SEE TDR, JUNE 23, 1997.)*

UroCor's business strategy is to provide value-added services to urologists. The company believes that its established relationship as a provider of diagnostics would be complemented if it also offered therapeutics. Further, after UroCor performs the diagnostic testing on the urologist's patient, it then has knowledge about the details of the patient's condition. Accordingly, UroCor believes that it is well-positioned to offer the urologist support in choosing the appropriate therapy, including pharmaceuticals.

Under its agreement with Zeneca, UroCor will offer two products for the treatment of prostate cancer. Next year UroCor expects to offer a therapeutic for treatment of bladder cancer, assuming that it passes FDA review.

UroCor's strategy seems aligned with market trends toward clinical integration. The company's goal is to become a preferred provider of disease management services to urologists. UroCor's efforts to combine diagnostics and therapeutics within the same company is a pioneering initiative. THE DARK REPORT is unaware of any laboratory which has successfully implemented a similar market plan.

UroCor demonstrated sustained revenue growth during the past six years. It is counting on its efforts with therapeutics to further boost revenues and operating profits. The company is well-respected for its management execution and marketplace performance. If it succeeds in marketing therapeutics to its urologist clients, it will make a relevant case study for how to deliver both therapeutics and diagnostics.

COMMERCIAL LABS GIVING UP HISTOLOGY & AP

THE DARK REPORT continues to get reports that the national laboratories are selectively reassessing their involvement in histology and anatomic pathology. This is occurring city by city. During the fee-for-service era, it was common for commercial laboratories to contract for AP services, then subcontract that work to local providers.

In recent years, these same laboratories have studied the profitability of different testing lines. Cytology and anatomic pathology are clear money-losers to the national laboratories, for a variety of reasons.

Since the national laboratories consider this segment of the business to be unprofitable, they are exploring ways to uncouple the AP work from clinical testing and let local providers contract directly. In certain cases, this can involve selling an existing histology laboratory currently owned and operated by the national laboratory. Interested pathology practices should stay alert to these opportunities. TDR

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Fast-growing specialty test provider **SpectraCell Laboratories, Inc.** of Houston, Texas announced the acquisition of **Southwest Hemostasis and Oncology Consultants, Inc.** (SHOC) of Dallas, Texas. SpectraCell offers assays that perform functional intracellular analyses of vitamins, antioxidants, minerals and amino acids.

ADD TO:...SPECTRACELL

SpectraCell's recent introduction of a homocysteine test and a Cardiovascular Risk Assessment Panel spurred its interest in acquiring SHOC. Under the direction of Chairman and CEO William Stanberry, Jr., SpectraCell is a fast-growing niche laboratory to watch.

Laboratories suspicious of "silent PPOs" should look to the example of North Carolina. Recent legislation now bans "silent PPOs." These are arrangements where third parties make unauthorized use of provider discounts. North Carolina law now prohibits brokers from engaging in this practice. It also requires the state insurance department to set limits on PPO products, including payment differentials, similar to rules governing HMO point-of-service products.

1998 PREMIUMS UP 3% FOR CALPERS

CalPERS, the California Public Employees Retirement System, provides coverage to more than 1 million beneficiaries. It announced an average premium increase of 3% for 1998. CalPers also declared its intent to seek bids for 1999 service from "lower-priced POS plans and exclusive provider plans."

MORE ON:...CALPERS

CalPers' goal is to improve access to specialists, minimize disruptions in doctor-patient relationships and create better access to healthcare in rural areas. CalPERS is closely watched as a market leader in the purchase of healthcare benefit programs. Besides signaling what kind of premium increase CalPERS deems reasonable for 1998, CalPERS' actions towards smaller managed care plans indicates an interest in supporting innovative organizations.

Latest word from the **Middle Tennessee Healthcare Network** is that the lawyers continue to haggle over the paperwork needed to legally charter the organization. As reported earlier this year, network organizers expected to be finished with this step and operational by November. *(See TDR, August 25, 1997.)* With 13 hospitals participating, it takes the skills of a diplomat to properly address the different needs of each institution. The network now expects to become operational in the first months of 1998.

Maybe laboratories should deal themselves into risk-sharing arrangements with managed care plans. **Deloitte & Touche** surveyed 260 large hospital institutions and discovered that more than half of those involved in risk-sharing arrangements received a surplus last year. Just under half of primary care physicians reported a surplus from risk-sharing, and less than 40% of specialists earned a surplus. The surplus kicker on a risk-sharing agreement can supplement capitated payments by a worthwhile amount if utilization stays within targeted levels.

That's all the insider intelligence for this report.
Look for the next briefing on Monday, December 29, 1997

THE DARK REPORT

UPCOMING...

- ***Top Ten Stories Of 1997: Events That Changed The Laboratory Marketplace.***
- ***Hospital Mergers, Acquisitions And Joint Ventures Continued At Record Pace In 1997.***
- ***More Upheaval Ahead For Pathology Practices: New Market Competitors Appear.***
- ***Capitated Reimbursement Trends For Laboratory Services Continue Downward.***