



# **Business Strategies for Developing Lab Outreach with an Eye to Eventual Sale**

**Earl Buck - May 15, 2008**

**Executive War College 2008 - Merger and Acquisition Day**

# Presentation Objectives

- ◆ **What does it take to create a hospital or health system-based outreach program that is a candidate for capital generation?**
- ◆ **Discussion today includes:**
  - ◆ **Why do people go into the lab outreach business?**
  - ◆ **How prevalent is lab outreach?**
  - ◆ **What are the key factors and trends related to lab outreach?**
  - ◆ **Why would a hospital or health system consider using the outreach program to generate capital?**
  - ◆ **What are the key areas requiring focus if capital generation becomes a strategy?**

# Why The Term Capital Generation vs. Divestiture?

- ◆ **Acute care facilities must have a clinical laboratory to service the needs of the physicians and patients.**
- ◆ **The majority of outreach programs are not organized, legally or physically, as a separable business units.**
- ◆ **While some have “sold” their business, most transactions require an ongoing relationship.**
- ◆ **Therefore, capital generation is a better term than divestiture.**
- ◆ **Requires “collaborative” arrangements among the parties with some level of capital generation for the hospital or health system.**

# Motivation For Lab Outreach

- ◆ **Recognition that “continuum of care” is an important strategy for hospitals and health systems. Related issue is continuity of the medical record across the inpatient, outpatient, and non-patient markets. Support of the medical staff is a related factor.**
- ◆ **Generation of revenue, margin, and capital, to benefit the organization and support new technology.**
- ◆ **Cost reduction via volume growth.**
- ◆ **Ability to support a broader test menu via higher volumes, new revenue and lower unit cost.**
- ◆ **Support of pathologist via increased volume of anatomic pathology specimens.**

# What Is The Progression of Lab Outreach Strategy?

## ◆ Conventional Lab Outreach - Phase I

- ◆ Hospital or health system related physicians and providers.
- ◆ Unrelated providers in the local market.
- ◆ Niche market or regional market.

## ◆ Aggressive Growth Strategy - Phase II

- ◆ Aggressive sales and marketing, networking, multi-lab integration and/or small acquisitions.

## ◆ Mature Strategies - Phase III

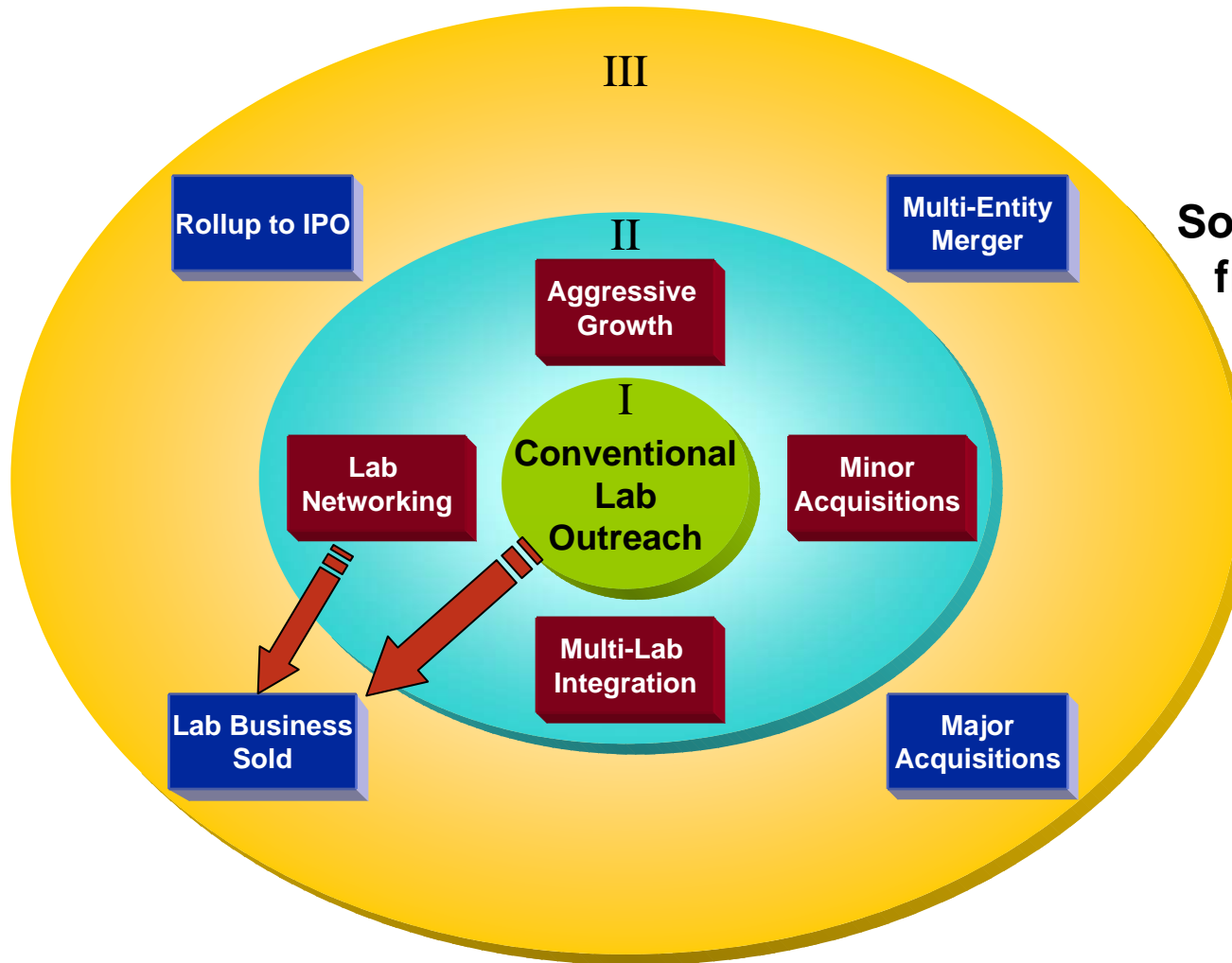
- ◆ Major acquisitions, mergers, divestiture or even IPO.

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◆ Majority of hospitals and health systems have not progressed beyond Phase II, with most satisfied to remain in Phase I.

# Lab Development Phases



**Some progress from Phase I directly to a Phase III capital generation strategy.**

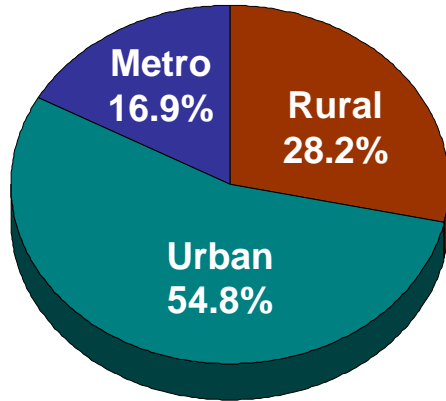
## Who Is In Lab Outreach?

- ◆ **79% of respondents to the 2006 Chi Solutions, Inc. Outreach Survey indicated they were involved in lab outreach. This leads to an estimate of ~1,526 hospitals involved in lab outreach in the U.S.**
- ◆ **Every hospital and health system type is represented in outreach.**
- ◆ **Size of program and level of maturity will vary. Estimates to be shown later in the presentation.**
- ◆ **Level of success based primarily on effective business and infrastructure strategies.**
- ◆ **Common issues exist among majority of hospital/health-system lab outreach programs.**

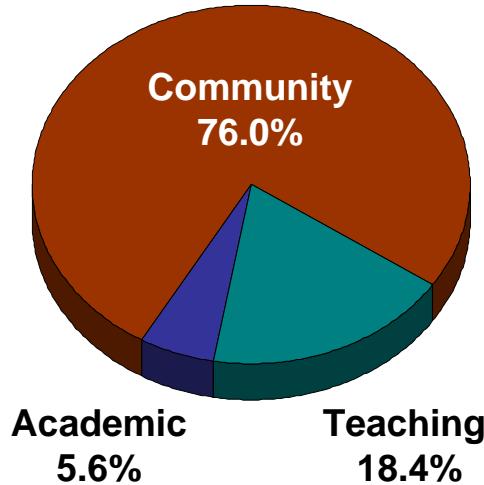
# Lab Outreach Respondent Profile

## FACILITY DESCRIPTORS

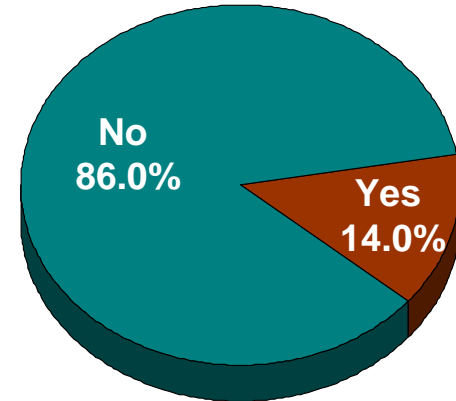
**Location**



**Institution Type**



**Children's Hospital**



Rural (area population <100,000)  
 Urban (area population >100,000 but <1 million)  
 Metropolitan (area population >1 million)

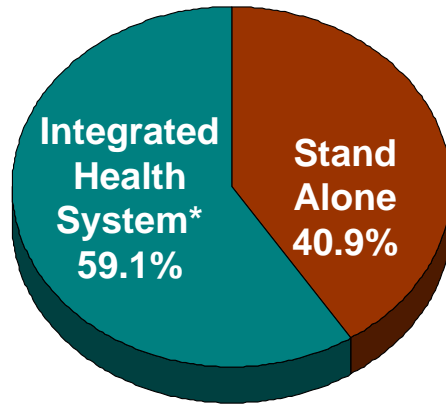
Number of Laboratory FTEs	
Maximum	425
Upper Quartile	130
Median	85
Lower Quartile	58
Minimum	10
Average (Mean)	106



# Lab Outreach Respondent Profile

## FACILITY DESCRIPTORS

### Respondent Status

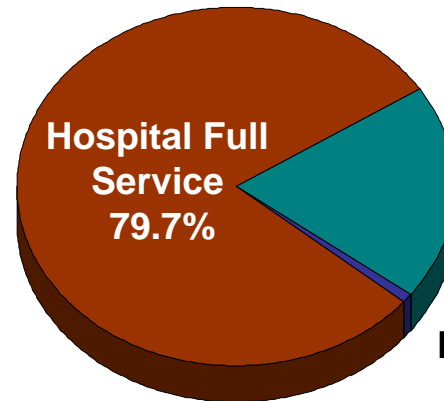


### Ownership

Government - 0.8%  
Investor Owned (for-profit) - 9.8%



### Laboratory Type



Multi-facility Core Lab - 19.5%

Independent Lab - 0.8%

*Hospitals in System	Number of System Beds
Maximum	7,766
Upper Quartile	1,000
Median	595
Lower Quartile	412
Minimum	180
Average (Mean)	
	1,062

# Benefits of Lab Outreach

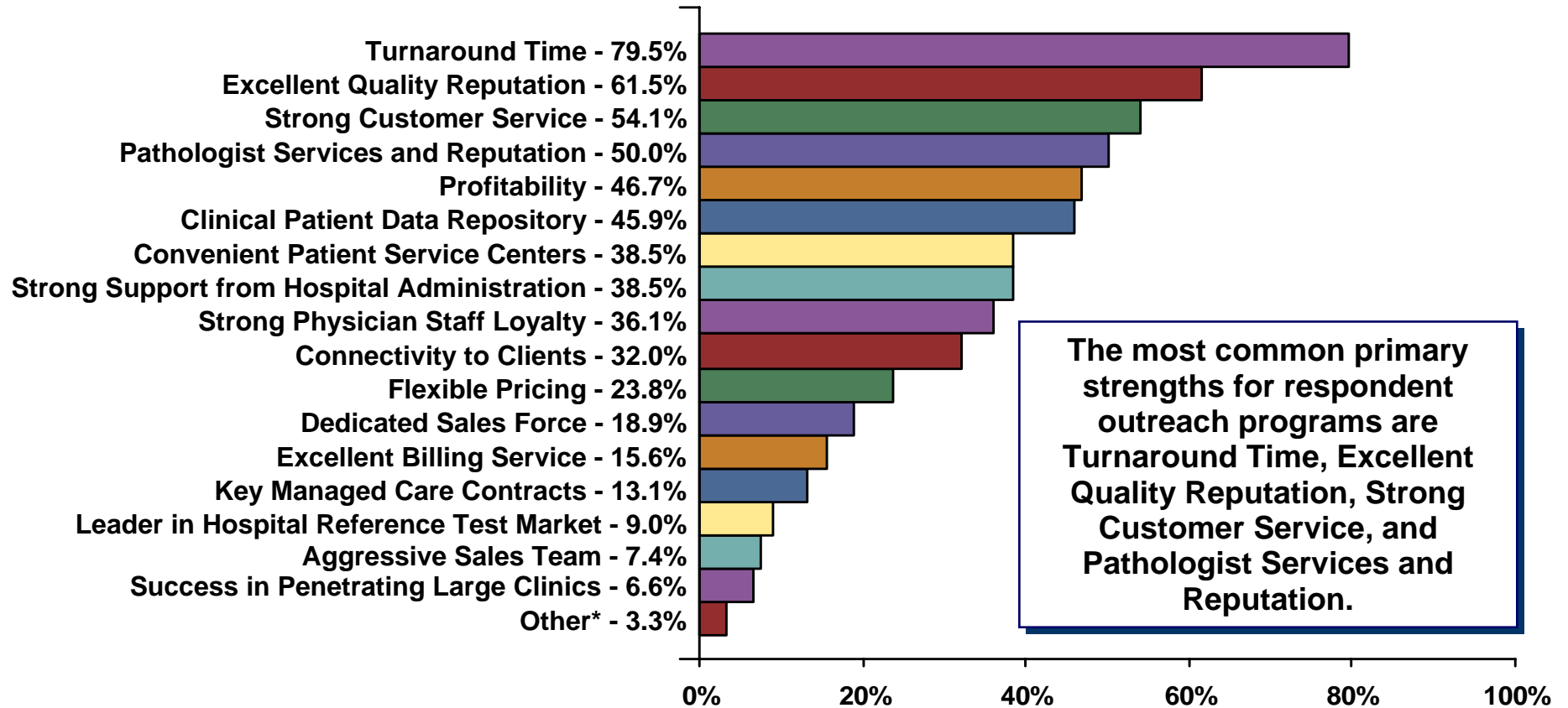
	Average Score*
Revenue and/or profitability	4.6
Extra volume allows for lower unit costs	4.4
Improved service to all patient types	4.1
Supports relationship building with the active medical staff	4.1
Creates and supports relationships with patients in the community or region	4.0
All inclusive laboratory database (patient encounters via hospital, physician practices, nursing homes, etc.)	4.0
Extra volume allows faster access to new technology	3.7
Other	3.5

\*1 = Least important; 5 = Very important

## Other Comments

- Continuity of care, reduced retesting.
- Extra volume improves productivity/efficiency

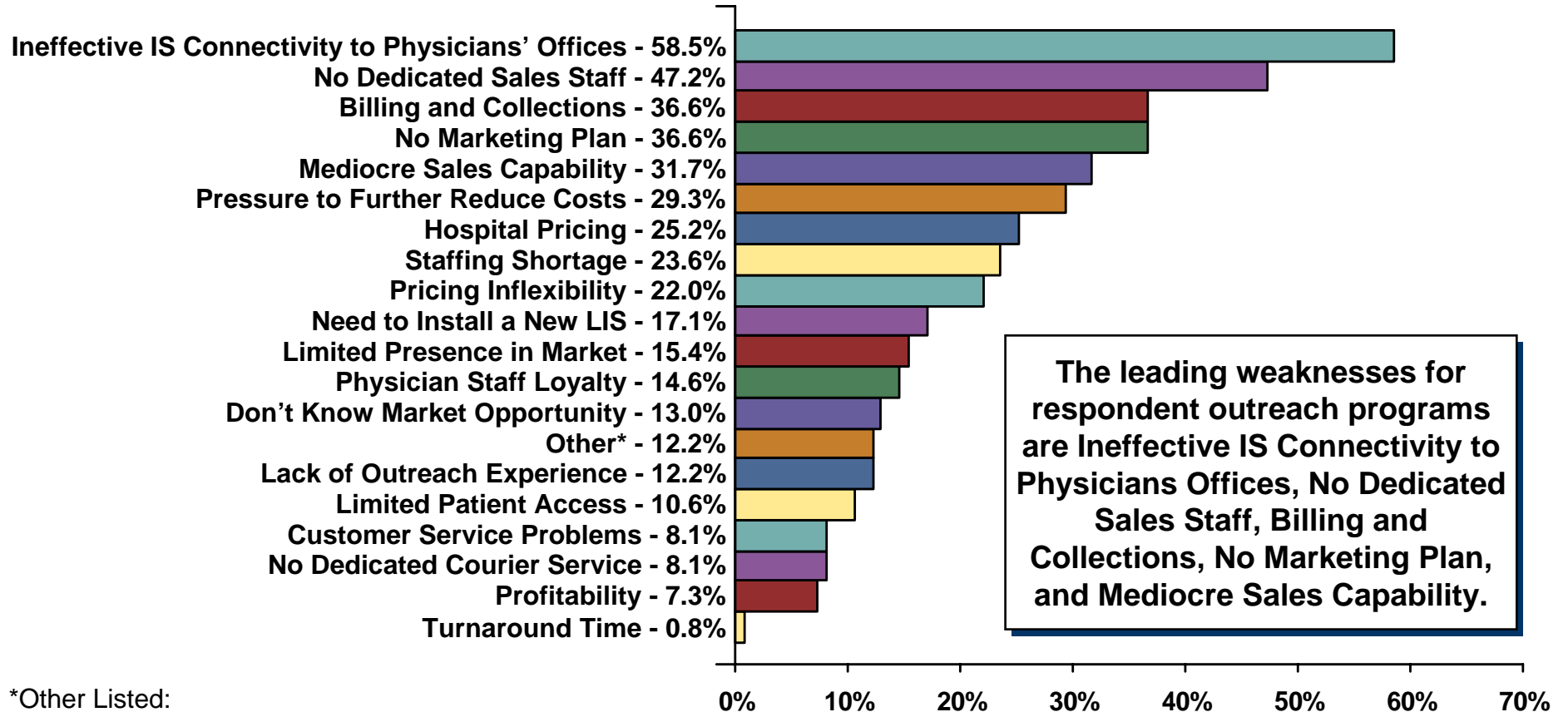
# Lab Outreach Strengths Per Operators



\*Other Listed:

- Community focus.
- Physician staff loyalty.
- Extensive testing menu; specialty/esoteric testing services.

# Lab Outreach Weaknesses Per Operators

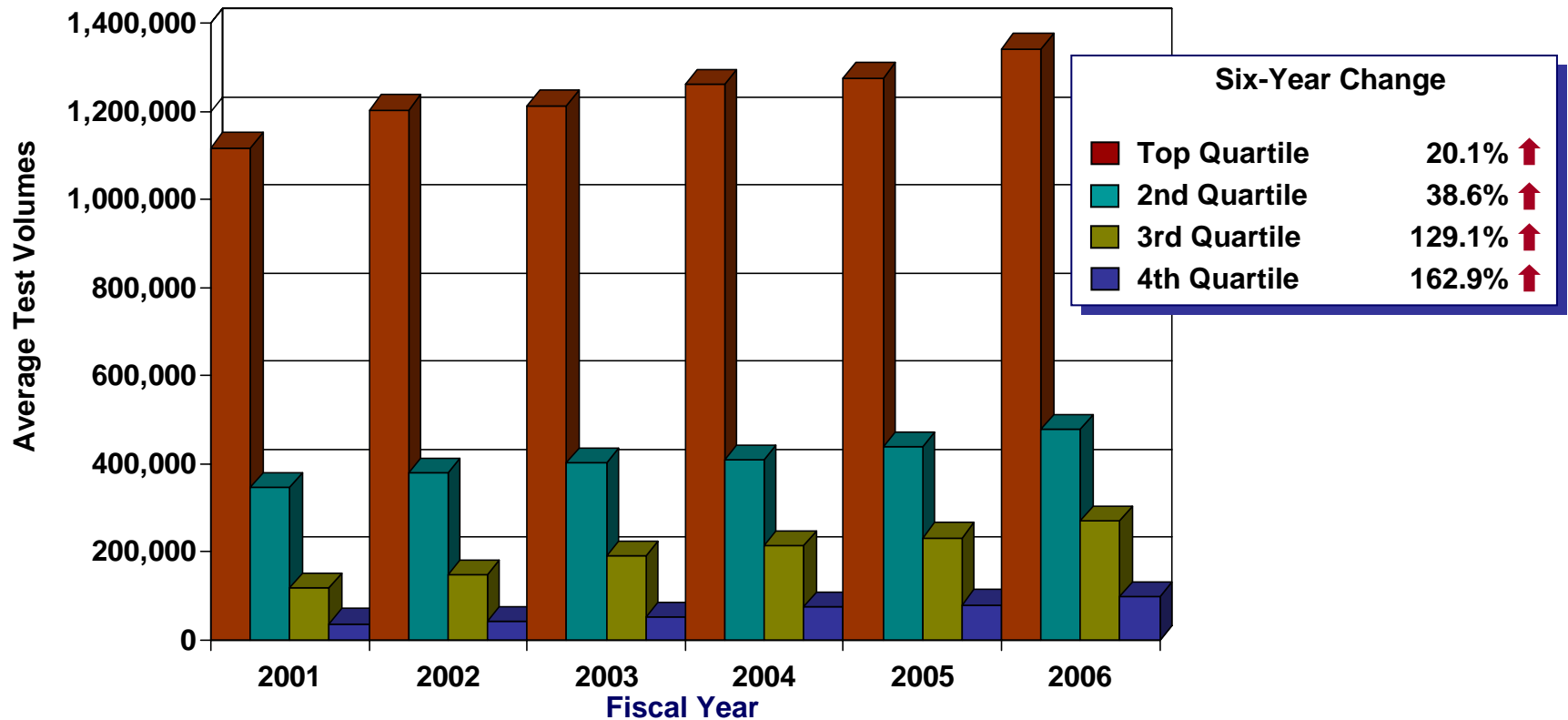


\*Other Listed:

- IS support, inability to obtain capital for connectivity
- Lack of support from large physician groups
- Balance between acute care and outreach
- Managed Care contracts
- Limited participation in competing system health plans
- Lack of good business data

# Lab Outreach Success

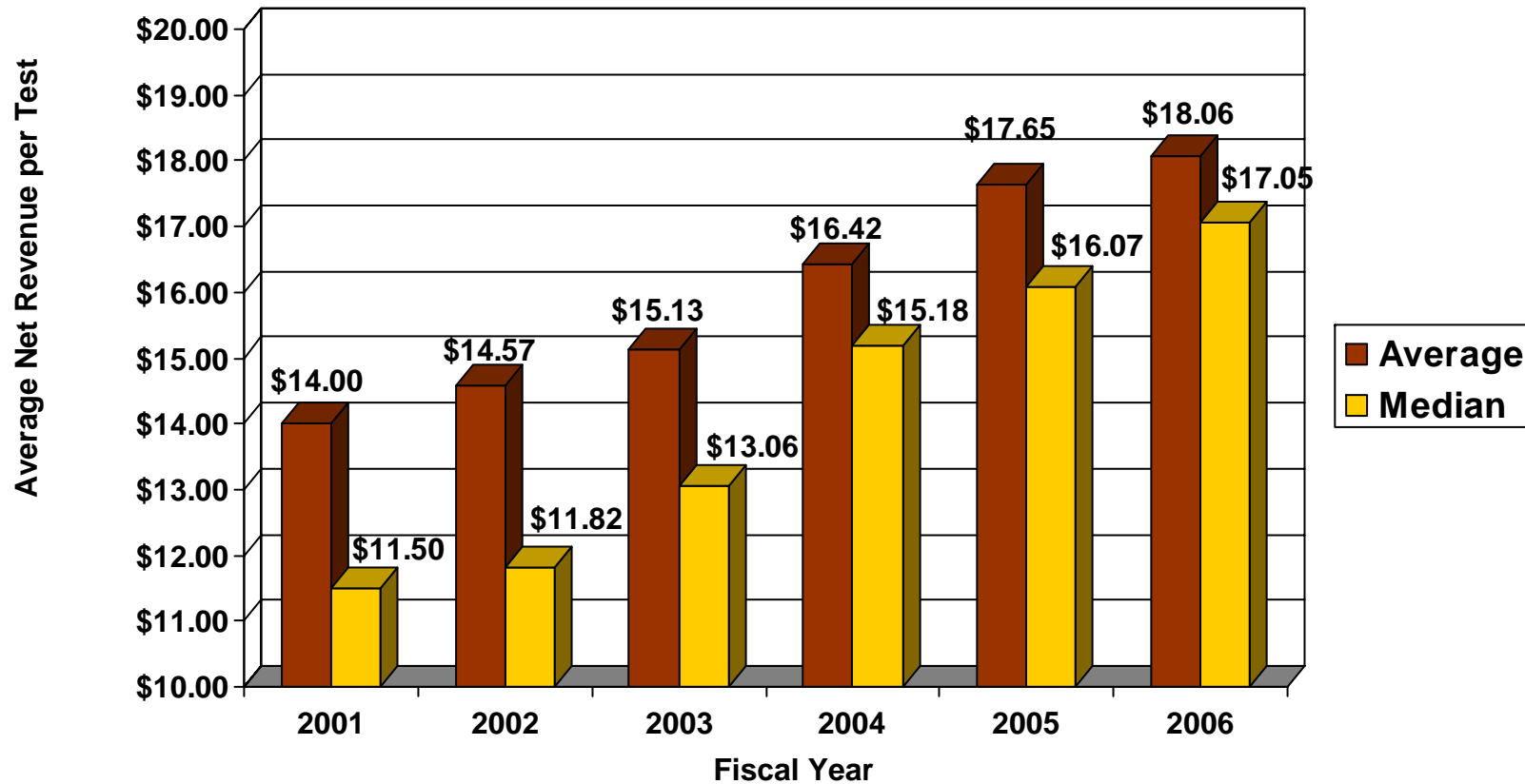
## VOLUME GROWTH OVER SIX YEARS



During the last two fiscal years, respondent outreach program average test volumes grew at an overall rate of 12.0%, or 6.0% per annum.

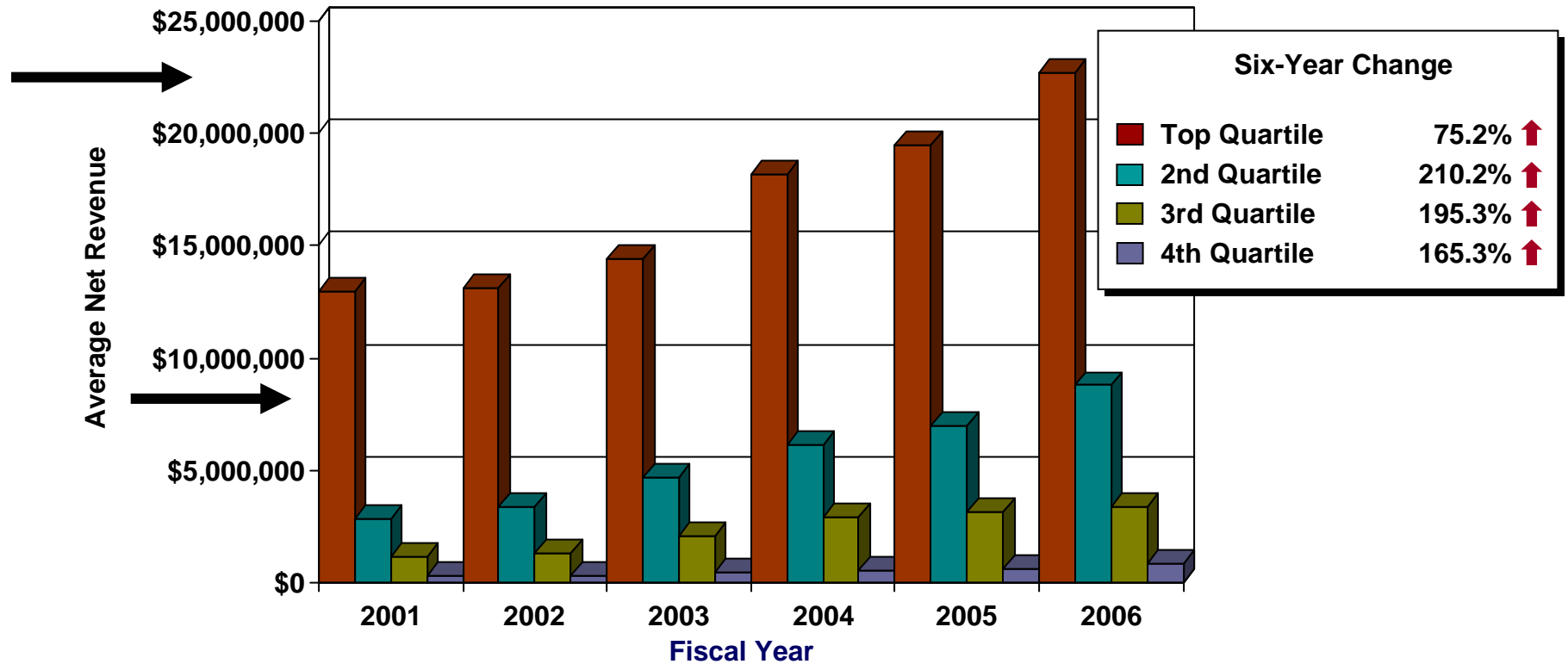
# Reimbursement Continues To Grow

## Average Outreach Net Revenue Per Test by Fiscal Year



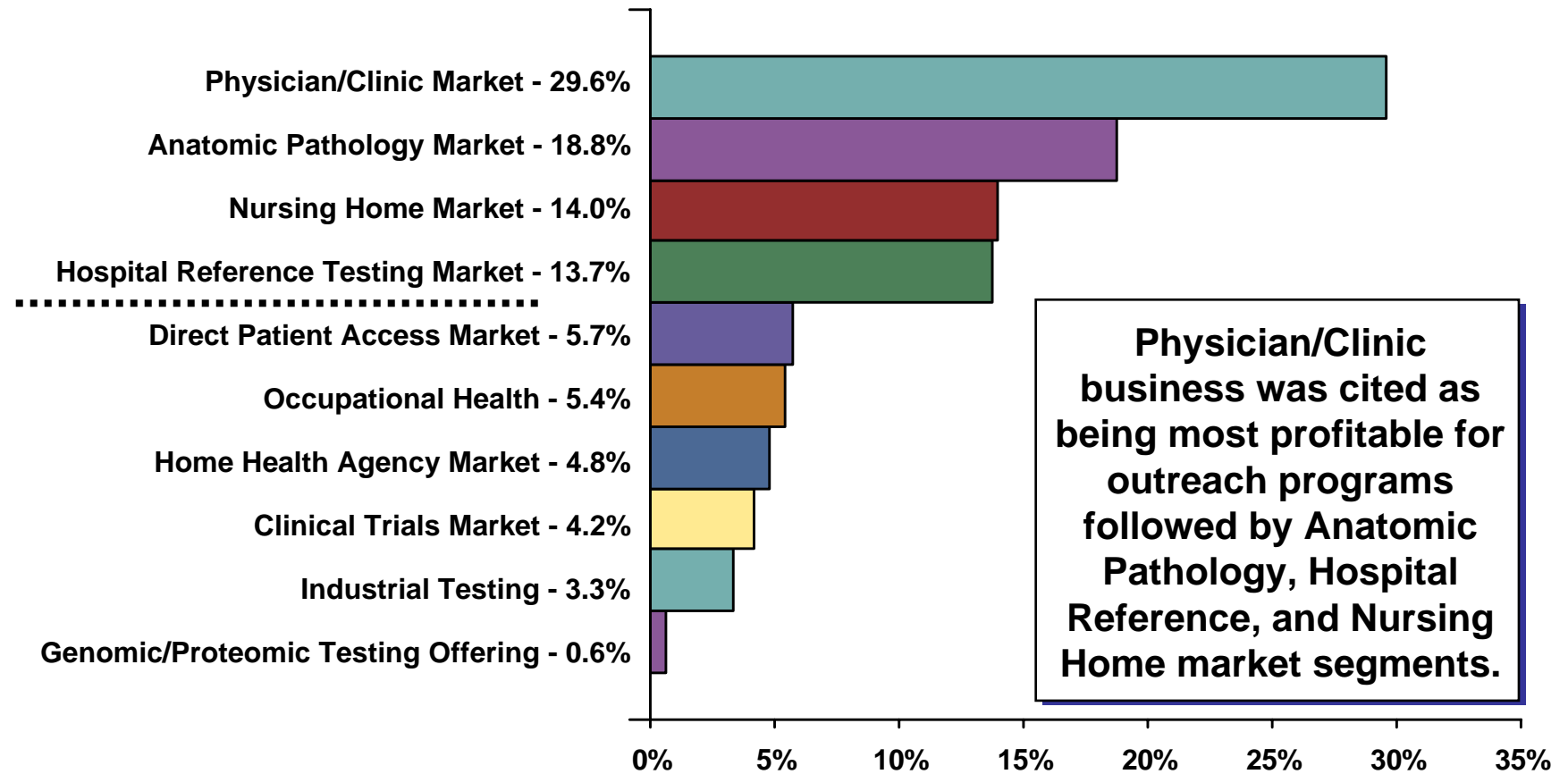
# Revenue Continues To Grow

## REVENUE GROWTH OVER SIX YEARS



Outreach revenue, on average, grew 22.5% for all respondents for the most recent two-year time period, or 11.3% annually.

# Profitability of Lab Outreach by Market Segment





# Lab Outreach Competitors 2004-2006

Laboratory	2004 Respondents	Percent of Total	2005 Respondents	Percent of Total	2006 Respondents	Percent of Total
Quest Diagnostics	114	37.6%	115	42.6%	71	29.6%
LabCorp	106	35.0%	96	35.6%	99	41.3%
Regional Hospital Outreach Program	42	13.9%	21	7.8%	27	11.3%
Regional Independent Laboratory	32	10.6%	31	11.5%	28	11.7%
Physician Group Laboratory	0	0.0%	4	1.5%	3	1.3%
Other*	9	3.0%	3	1.1%	12	5.0%
<b>TOTAL</b>	<b>303</b>	<b>100.0%</b>	<b>270</b>	<b>100.0%</b>	<b>240</b>	<b>100.0%</b>

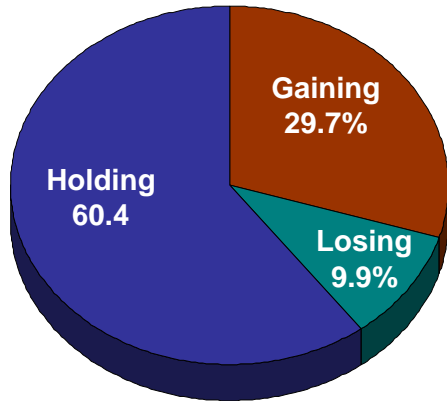
**\*Other Listed:**

- LabOne
- Mayo
- Spectrum
- Specialty
- UniLab
- Various other listed laboratories

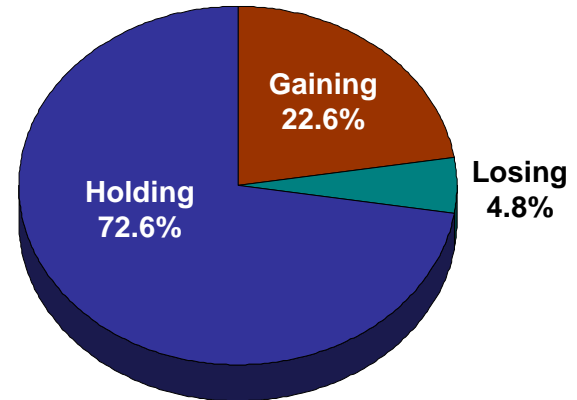
**LabCorp is the most important competitor to survey respondents followed by Quest Diagnostics. Regional independent laboratories are in third place, followed closely by regional hospital outreach programs.**

# Progress vs. Competition

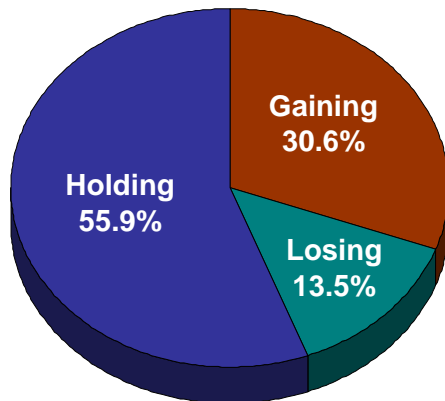
## MARKET SHARE EXPERIENCE



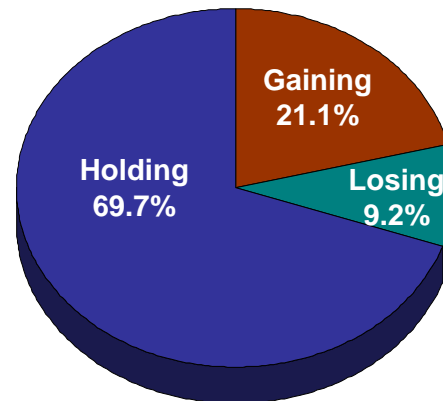
vs. Quest Diagnostics



vs. Key Hospital Outreach Program



vs. LabCorp

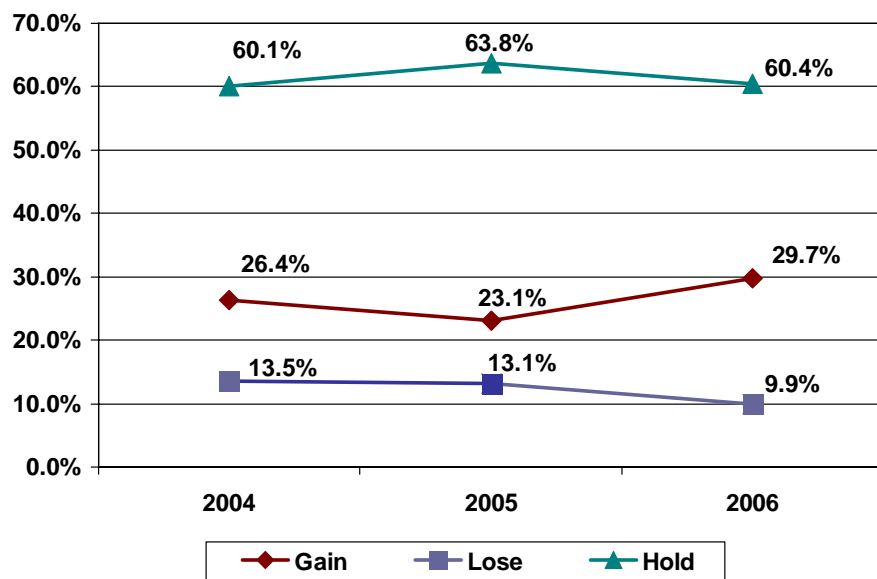


vs. Key Local Lab

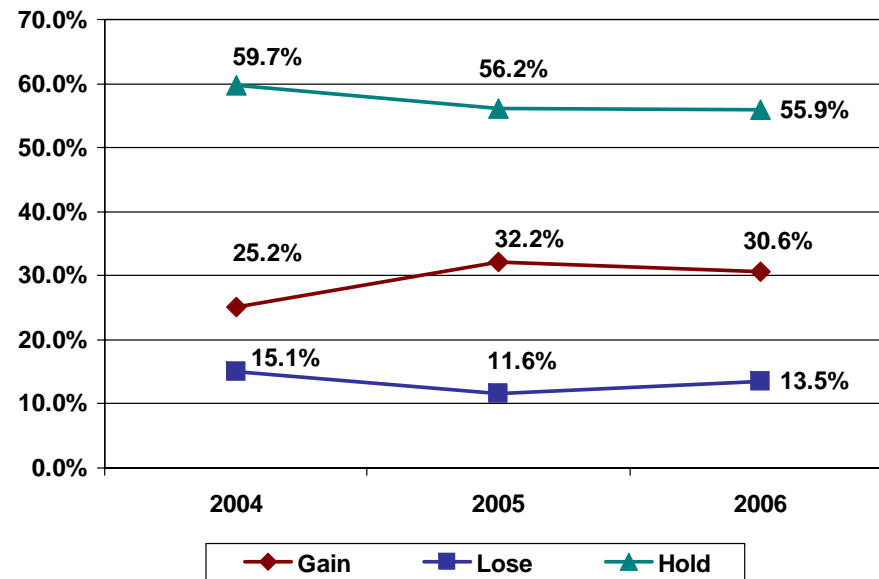
# Three Year Trends vs. National Labs

## MARKET SHARE EXPERIENCE

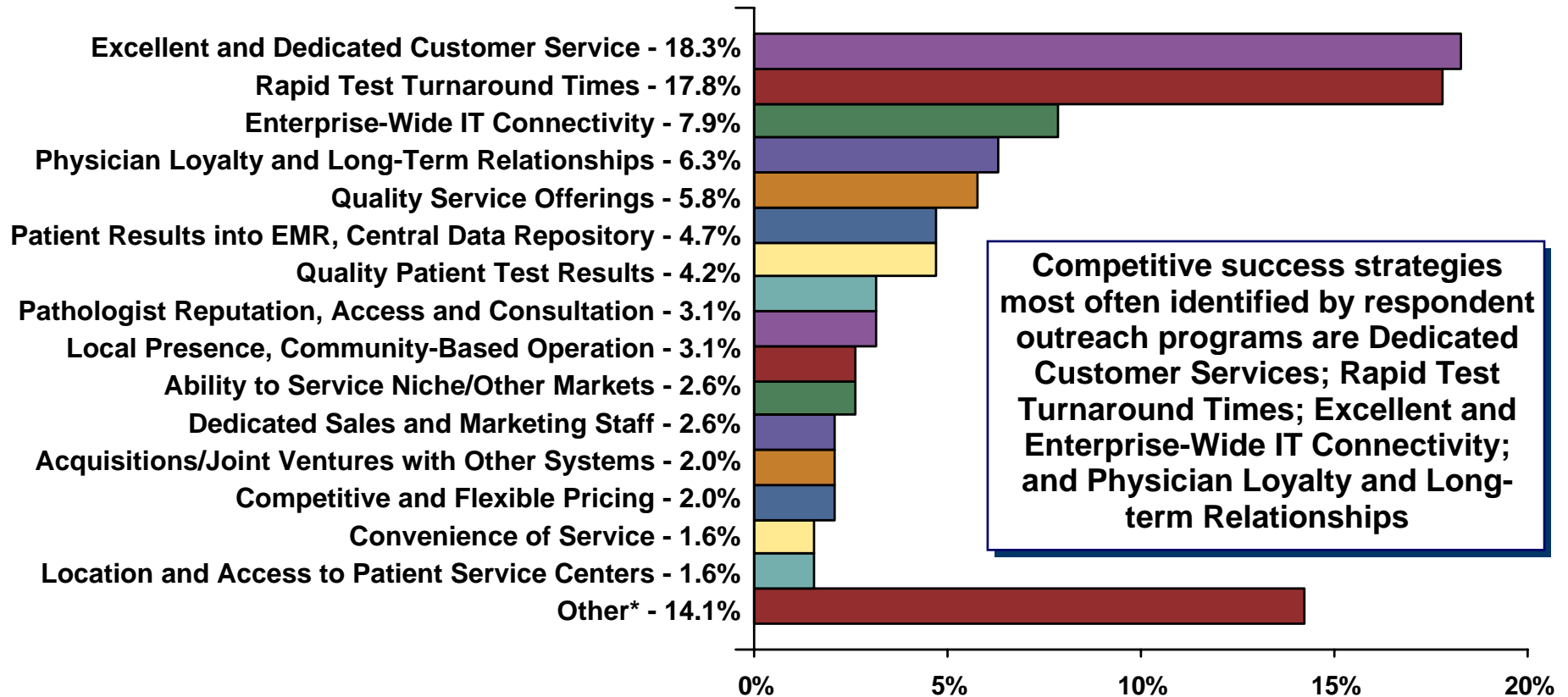
### vs. Quest Diagnostics



### vs. LabCorp



# Strategies To Compete

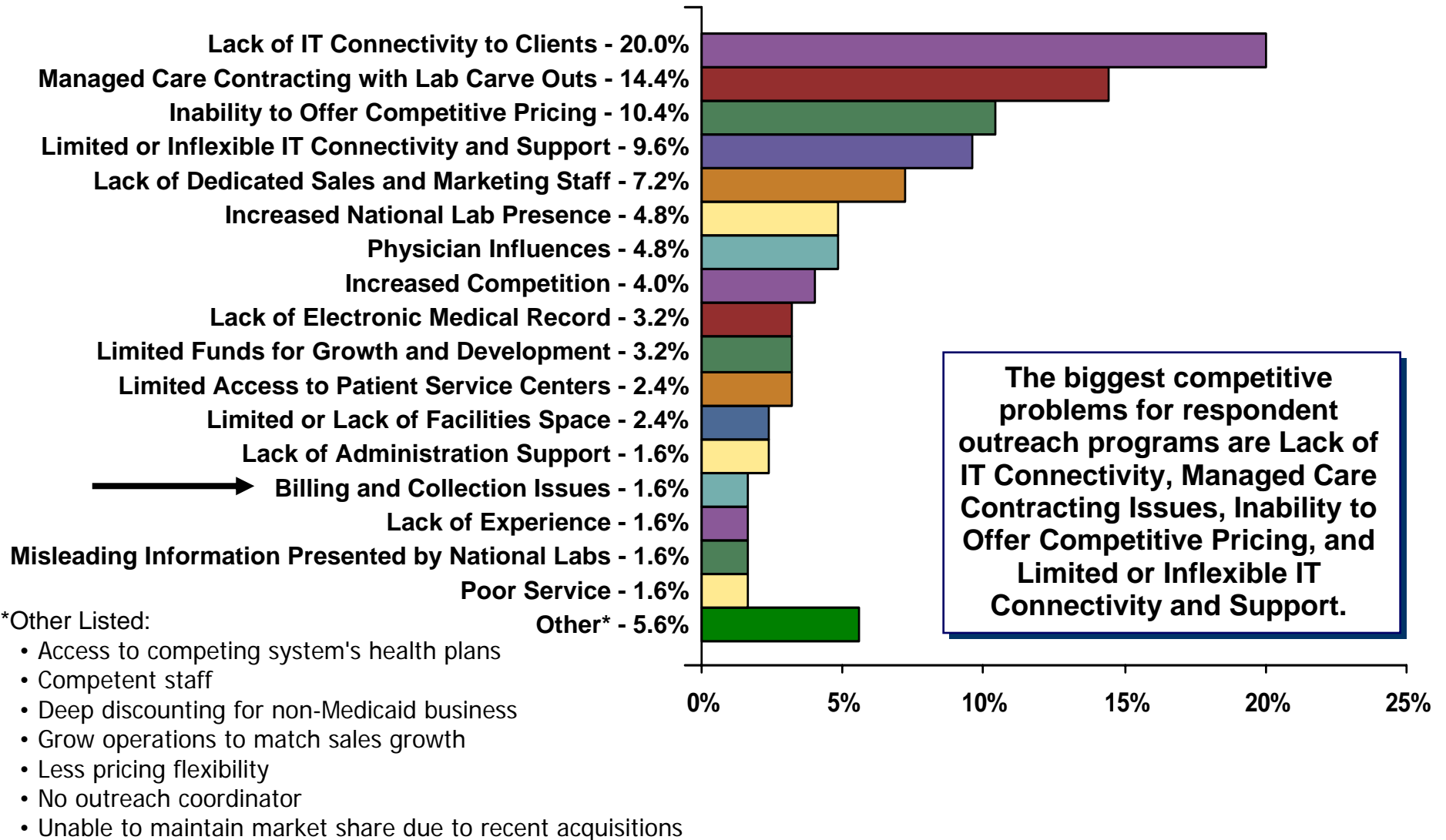


**\*Other Listed:**

- Anatomic pathology services within the community
- Becoming a training facility
- Continuum of care
- Coordinated strategy for all hospital services
- Courier services for multiple pick-ups, STATS, etc.
- Customer loyalty
- Global billing and sub-specialties for anatomic pathology
- Joint ventures with Quest Diagnostics

- Limited number of staff who interface with physicians
- Provide management consulting services
- Providing medical directorship
- Robotic lab
- System networks
- Taking advantage of the UHC - LCA decision
- Tech support program
- Technical expertise
- Test availability

# Competitive Issues



# Billing Focus/Awareness

**Billing is not considered a significant competitive issue, yet is a problem for the majority of outreach programs.**

## ACCESS TO BILLING INFORMATION

	Yes	No	Unsure
Access to net revenue information?	45.8%	46.6%	7.6%
	Hospital	Outside	
Billing performed by hospital or outside service?	77.5%	21.1%	
	Yes	No	Unsure
Ability to obtain billing information by:			
• Client	75.0%	22.1%	2.9%
• Sales Representative	15.2%	77.3%	7.6%
• Courier Route	4.5%	89.4%	6.1%
• Market Segment	47.7%	45.2%	6.2%

# Billing Focus/Awareness

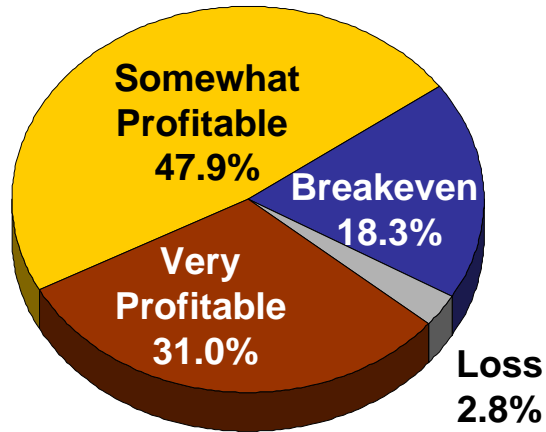
## ACCESS TO BILLING INFORMATION

	Yes	No
Do you use the hospital's provider number for outreach billing?	83.5%	16.5%
	Yes	No
Do you have an audit process to ensure Medicare billing compliance?	88.3%	11.7%
	Yes	No
Do you receive reports trending Medicare denials?	56.2%	43.8%
	Yes	No
Do you have a process for reviewing claims that have been denied for medical necessity?	75.8%	24.2%
	Yes	No
Are you confident that you are collecting everything you can?	32.5%	67.5%

# Understanding of Profitability

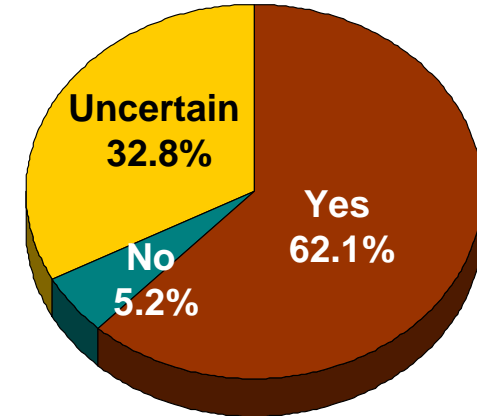
## BELIEF THAT YOUR OUTREACH PROGRAM IS PROFITABLE

### General Opinion

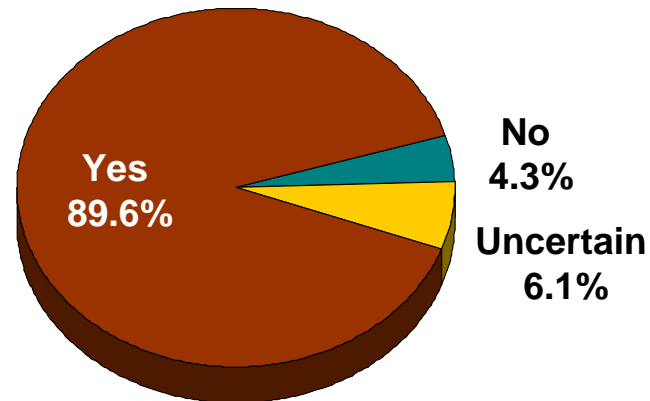


- 78.9% indicated that their programs were very or somewhat profitable

### Chief Financial Officer



### Survey Respondent





# Profitability Management

## PROFITABILITY REVIEW

	Yes	No	Unsure
Has your outreach profitability been analyzed?	65.3%	23.1%	11.6%
	Actual	Estimated	Unsure
Was net revenue actual or estimated?	49.4%	43.5%	3.4%
	Yes	No	Unsure
Expenses included:			
• Hospital overhead	50.0%	45.1%	4.9%
• Laboratory administration	75.9%	21.7%	2.4%
• Outreach support	90.1%	3.7%	6.2%
	Average	Incremental	Unsure
Technical costs based on:			
• Average or Variable/Incremental	21.8%	58.6%	19.5%

**Understanding of outreach program profitability is sometimes secondary to the purpose for the program.**

# Contribution Margin of Lab Outreach

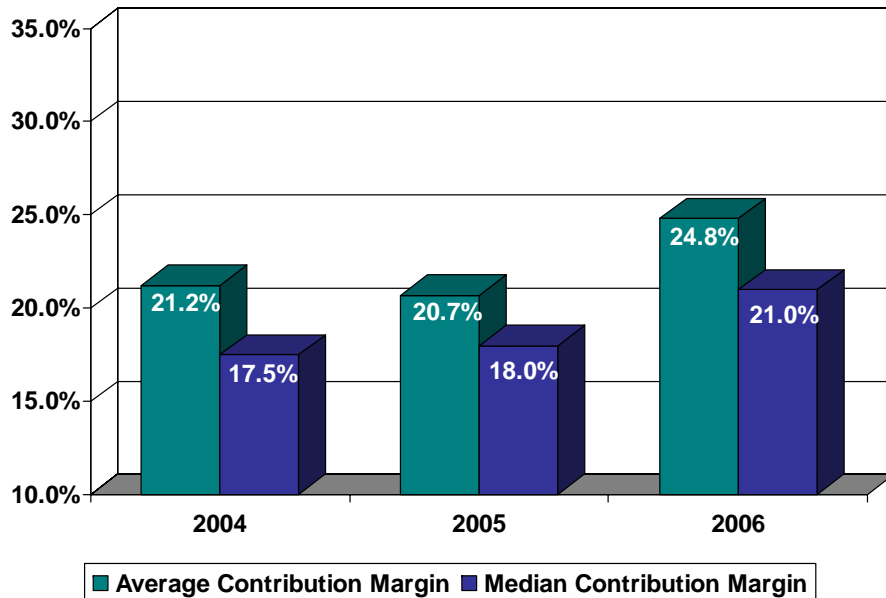
	<b>Core Laboratory (7)</b>	<b>Full-Service Hospital Laboratory (24)</b>
	<b>% Contribution Margin</b>	<b>% Contribution Margin</b>
<b>Maximum</b>	<b>59.0%</b>	<b>60.0%</b>
<b>Upper Quartile</b>	<b>41.0%</b>	<b>33.9%</b>
<b>Median</b>	<b>30.0%</b>	<b>21.0%</b>
<b>Lower Quartile</b>	<b>14.0%</b>	<b>13.5%</b>
<b>Minimum</b>	<b>9.5%</b>	<b>1.6%</b>
<b>Average (Mean)</b>	<b>29.8%</b>	<b>24.8%</b>
<b>Standard Deviation</b>	<b>18.7%</b>	<b>15.7%</b>
<b>Maximum</b>	<b>\$ 27,200,000</b>	<b>\$ 38,100,000</b>
<b>Upper Quartile</b>	<b>\$ 14,810,936</b>	<b>\$ 7,516,397</b>
<b>Median</b>	<b>\$ 9,734,000</b>	<b>\$ 3,629,331</b>
<b>Lower Quartile</b>	<b>\$ 5,925,116</b>	<b>\$ 951,209</b>
<b>Minimum</b>	<b>\$ 1,200,000</b>	<b>\$ 100,000</b>
<b>Average (Mean)</b>	<b>\$ 10,756,564</b>	<b>\$ 6,693,470</b>
<b>Standard Deviation</b>	<b>\$ 7,067,203</b>	<b>\$ 9,158,541</b>

Note: Contribution Margin is net revenue less direct operating expenses for incremental testing.

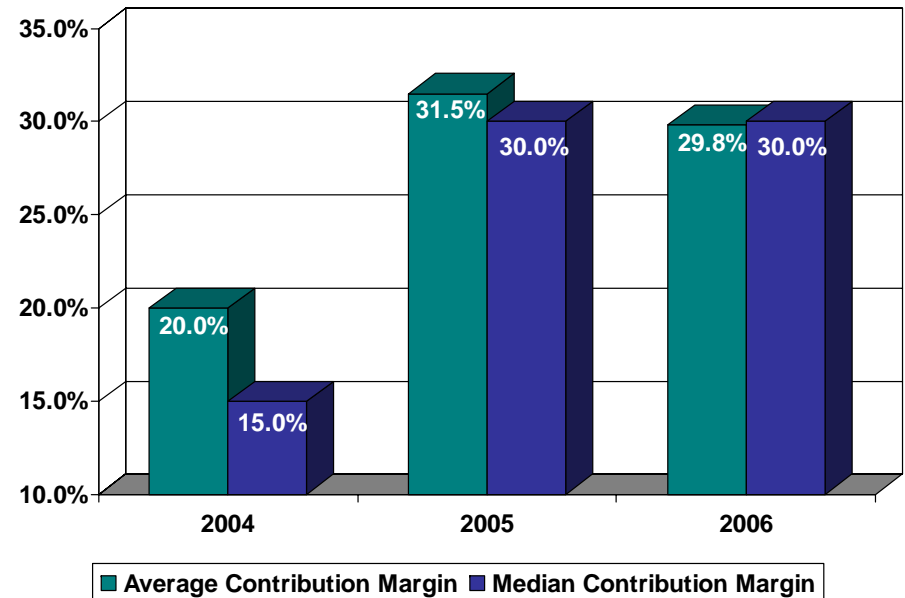
# Contribution Margin Trends

## CONTRIBUTION MARGIN- LAST THREE YEARS

### Full-Service Hospitals



### Core Laboratories



# Why Look at Divestiture or Capital Generation?

- ◆ Many programs are reaching a more mature status.
  - ◆ There is an aging of laboratorians → pathologists, managers, and other leaders.
  - ◆ Strategic initiatives change and require new sources of capital to fund top priorities.
  - ◆ M&A activity within the industry seems to be increasing.
  - ◆ Prices seem to be attractive for well run programs.
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- ◆ What does the history look like?



# M&A Activity: 2001 → 2007

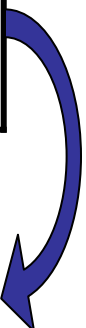
Year	2000	2001	2002	2003	2004	2005	2006	2007
N	14*	13	9	15	18	14	25	18
Purch. \$\$ (M)	\$899	\$566	\$1,335	\$2,362	\$513	\$1,661	\$2,130	\$3,100
Net Rev \$\$ (M)	\$534	\$327	\$627	\$1,147	\$308	\$926	\$765	\$1,268
Multiple	1.42	1.57	2.07	1.71	1.55	1.72	2.9	2.7
Net Rev Range	\$5 – \$230	\$1 – \$63	\$5 – \$269	\$0.4 – \$479	\$5 – \$125	\$2 – \$468	\$3.5 – \$358	\$15 – \$760

\* Includes two IPO's

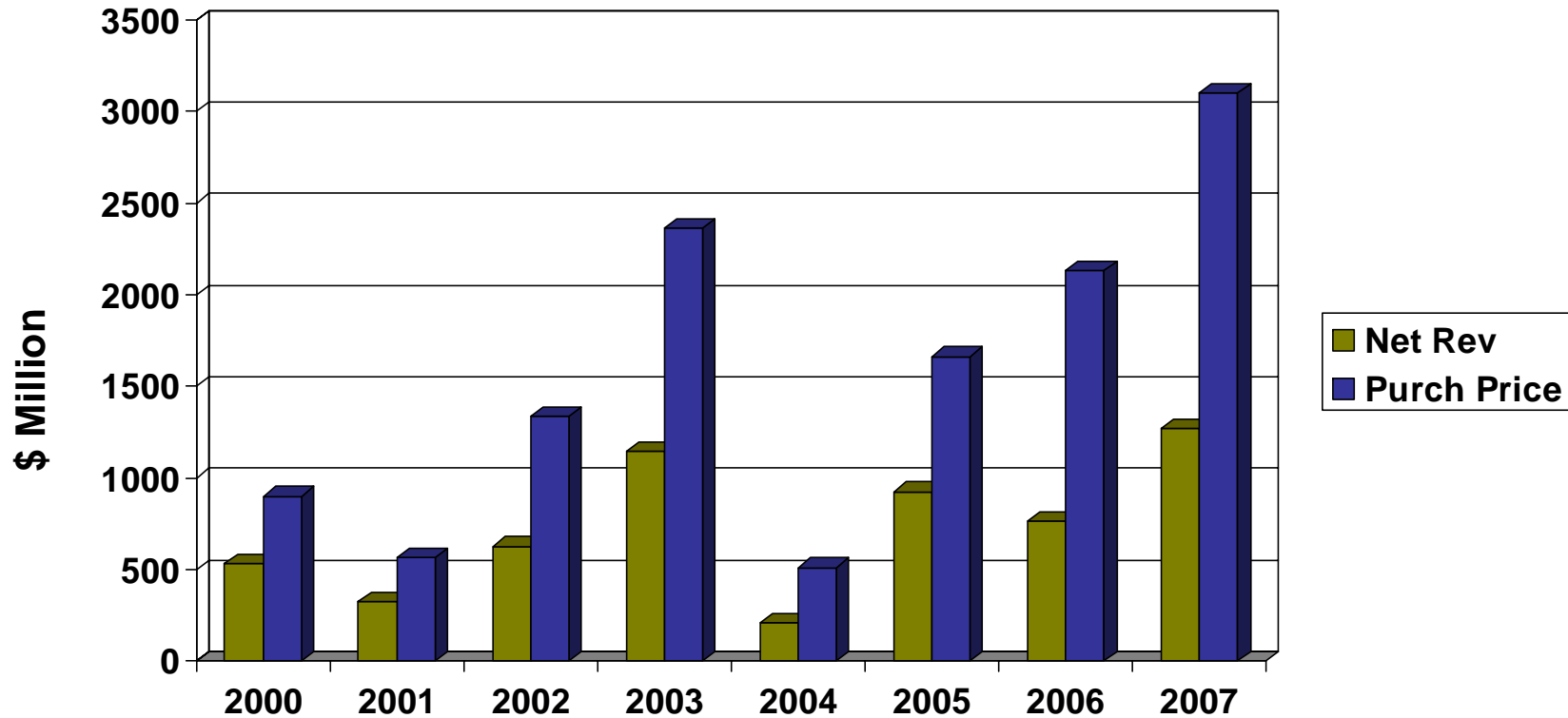
**Resource:**

- Lab Industry Strategic Outlook 2007, G-2 Reports.
- Lab Industry Report, February 2007.
- Note: Not all data disclosed by the parties.

**Small labs remain as targets throughout the period**



# M&A Activity: 2001 → 2007



**Resource:**

Lab Industry Strategic Outlook 2007, G-2 Reports.

Lab Industry Report, February 2007.

Note: Not all data disclosed by the parties.

# M&A Activity: 2001 → 2007 - Large Players

## ◆ LabCorp

- ◆ 21 acquisitions at \$1.935 Billion

## ◆ Quest Diagnostics

- ◆ 12 acquisitions at \$5.085 Billion

## ◆ Sonic Healthcare

- ◆ 4 acquisitions (U.S.) at \$468 Million

## ◆ Other venture capital groups enter as well

- ◆ Apax Partners
- ◆ Parthenon

# What Should The Focus Be?

## ◆ Same focus as needed to run a successful program...

- ◆ Web connectivity to be competitive in the market.
- ◆ Planned growth via formal sales and marketing activity.
- ◆ Effective billing that allows a detailed understanding of actual reimbursement and net revenue (usually requires external billing solution).
- ◆ Ability to document profitability of the program, to include the net revenue, variable and non-variable expenses and profit (or contribution margin).

## ◆ Is the program positioned for potential sale...

- ◆ Is program structured in a way that allows for sale of a business unit.
- ◆ Is the program located in a setting amenable to a sale.
- ◆ Are the financials for the program separated from hospital operations.



# Implications of Divestiture or JV

**Be prepared to negotiate in a way that anticipates how to effectively monitor and manage the following:**

- ◆ **Impact on laboratory services to hospital patients.**
- ◆ **Impact on laboratory services provided to patients in the community and their physicians.**
- ◆ **Impact on laboratory staff.**
- ◆ **Impact on pathologists.**

# Conclusion

**Divestiture or joint venture related to laboratory outreach is an option that some will pursue when:**

- ◆ **Capital is needed to support more important strategies**
- ◆ **Capital and effective management is needed to ensure future success, and a partnering relationship is acceptable**
- ◆ **Owners determine it's time to execute the “exit” strategy**
- ◆ **A “successful” program is now meeting with level or declining revenue base, or declining financial performance, and the owners believe they can no longer compete**

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**Whether selling/JV is an intended strategy or not, to maximize future value, always operate the program for the best success and employ effective business strategy with professional management.**