White Paper:
The Top Five Outreach Industry Trends

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Final

Introduction

For the past eight years, Chi Solutions, Inc. (Chi) has conducted its Comprehensive National Laboratory Outreach Survey to identify hospital laboratory outreach industry trends. The results of this nationally-recognized survey provide essential information on a variety of outreach program characteristics, including financial performance, competition and market share, competitive challenges and success strategies, billing practices and financial management metrics, quality, and merger and acquisition activity.

This paper presents a countdown of the top five outreach industry trends based on findings from Chi's eighth annual survey conducted in the spring of 2009 as well as Chi's extensive experience with and knowledge of laboratory outreach.

Trend #5: The Profile of a "Typical" Outreach Program

This trend highlights the characteristics of a typical outreach program. Of over 150 survey respondents from across the nation, 78 percent responded that their facility has a laboratory outreach program. Using the information provided by those respondents, averages for a variety of factors were determined and are indicated in Table 1 below.

Table 1: "Typical" Outreach Program Characteristics

Net Revenue	$13.5 million
Revenue per Test	$26.38
Revenue per Requisition	$65.95 (based on 2.5 tests per requisition)
Growth	Volume: (2.2)% Net Revenue: 3.2%
Profitability	20-27%
Competitive Problems	Connectivity, pricing, managed care
Billing	Hospital
Bad Debt	10%
DSO	58 days

With regards to financial performance, survey results indicate that net revenue has grown considerably over the years to reach an average of $13.5 million. Similarly, revenue per test and requisition have increased year to year and now average $26.38 and $65.95, respectively. While volume growth has decreased by 2.2 percent since the previous year's survey, annual net revenue has increased by 3.2 percent. Profitability is in the 20 to 27 percent range, averaging about the same as in prior surveys.

Over the eight years that Chi has conducted its outreach survey, the most frequently mentioned competitive obstacles have been connectivity, pricing, and managed care. It is no surprise that lack of connectivity to clients is the number one disadvantage for hospital outreach programs today, as the ability to provide test ordering and results electronically and to interface with

electronic medical records (EMRs) is certainly a crucial differentiator in today's market. The ability to price competitively and secure managed care contracts to compete with the national laboratories also pose significant problems for hospital outreach programs.

As shown in the table above, billing for most laboratory outreach programs is performed by the hospital billing department. Survey respondents experienced an average bad debt rate of 10 percent and days sales outstanding (DSO) of 58 days. Discussion of the next trend will illustrate how these metrics as well as other key indicators of the typical outreach program stack up against the major national laboratories.

Trend #4: Performance of Hospital-based Outreach Programs is Strong

When compared to the national laboratories on several key financial and operational metrics, hospital-based laboratory outreach programs appear to be holding their own. Table 2 shows outreach program performance versus the two major national laboratory competitors: Quest Diagnostics (Quest) and LabCorp. The green highlighted boxes indicate areas in which outreach program performance is better than Quest and LabCorp; the red box signifies poorer performance than the national laboratories.

Table 2: Outreach Program Performance vs. National Laboratories

	Outreach Program	Quest Diagnostics	LabCorp
Revenue per Requisition	$65.95	$43.00	$38.38
Volume*	(2.2)%	(0.4)%	9.8%
Revenue Growth*	3.2%	8.1%	10.7%
Profitability**	20-27%	13.7%	17.8%
Bad Debt	10%	4.8%	5.3%
DSO	58 days	44 days	51 days

*Year-over-year increase.
**Measured as contribution margin or pre-tax profit.

Outreach programs measure up quite favorably on revenue per requisition, averaging almost $66 compared to Quest's $43 and LabCorp's $38. The higher figure for hospital-based programs can be attributed to the fact that they operate on different fee schedules than the national laboratories. Also, some hospitals still have "percent of charges" arrangements with insurance companies. If a hospital has an agreement for reimbursement of, for example, 80 percent of charges, they are likely to receive higher reimbursement for the amount they bill than a laboratory that has a defined fee schedule. While these types of contracts are not as common today, they are one of the reasons why hospitals' revenue per requisition is so high. Some hospital laboratories with such arrangements have seen revenue per requisition of over $100.

For the most part, decrease in volume has been a national trend for the past year. As indicated in Table 2, volume was down 2.2 percent for outreach programs and 0.4 percent for Quest. LabCorp, however, represents an outlier to this overall trend, experiencing a volume increase of

almost 10 percent. This is primarily due to LabCorp's recent acquisition strategy which has focused on esoteric laboratories as demand for genetic testing has exploded.

Turning to profitability, outreach programs appear to be faring well in the 20 to 27 percent range. One caveat must be taken into account: the Quest and LabCorp numbers represent pre-tax profit, which includes some overhead, as opposed to the outreach program figures, which are expressed as contribution margin excluding overhead. However, factoring some overhead into the outreach program profitability would most likely still result in numbers comparable to, if not better than, the national laboratories.

Bad debt is one area in which hospital-based programs perform poorly compared to their national competitors. As mentioned previously, hospital billing departments handle billing for most outreach programs. These departments, however, may lack the front-end systems, focus, and follow through of expert, dedicated laboratory billing companies. Laboratory outreach is often not a major priority for hospital billing departments, as the collection amounts for laboratory services pale in comparison to the hundreds of thousands of dollars that hospital billing departments pursue for services overall. Additionally, the average revenue per laboratory requisition of $65.95 is very close to the $50 write-off amount for many hospitals.

For similar reasons, the DSO for outreach programs is also quite high–58 days compared to Quest at 44 and LabCorp at 51. Many hospitals simply do not have adequate systems or the ability to appropriately focus on billing and collection for the outreach program when it is blended in with hospital billing as a whole. The longer it takes to collect the money for services, the worse the business' overall financial performance.

Trend #3: Merger and Acquisition Activity is Not Dead

The next trend on the countdown indicates that, despite the considerable decrease of laboratory mergers and acquisitions, such activity has not ceased completely. Merger and acquisition activity in the laboratory business usually involves hospitals selling their outreach business or independent laboratories selling their company to one of the large national laboratories (e.g., Quest and LabCorp) or an international laboratory such as Sonic. However, regional laboratories have also used acquisitions as a means to increase their business base more rapidly than they would organically through the addition of new clients.

Chi's survey findings provide evidence of the willingness of regional laboratories to employ this strategy. Respondents were asked to indicate whether or not their hospital: (1) had been approached about selling its laboratory outreach program, (2) was likely to sell the outreach program, and (3) was considering acquisition of another outreach program or laboratory. As Figures 1 and 2 show, 10 percent responded affirmatively to the hospital being approached about a sale and 12 percent said that a sale was either likely or somewhat likely. Most interesting, however, are the responses to the third question: 15 percent of the surveyed organizations were considering an acquisition (Figure 3), a greater figure than those interested in selling their own program. It should be noted that there may be some bias in reporting these figures since the respondents were comprised of laboratory personnel, who are often the last to know about a contemplated outreach program or laboratory sale.

Figure 1: Hospital Approached About Selling Outreach Program to Competitor

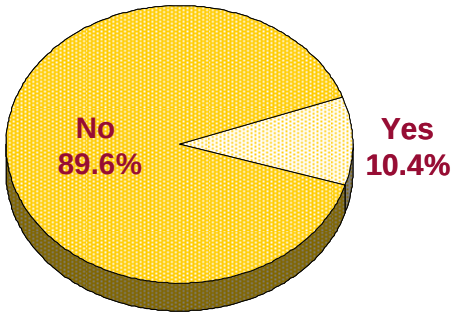


Figure 2: Likelihood of Outreach Program Sale

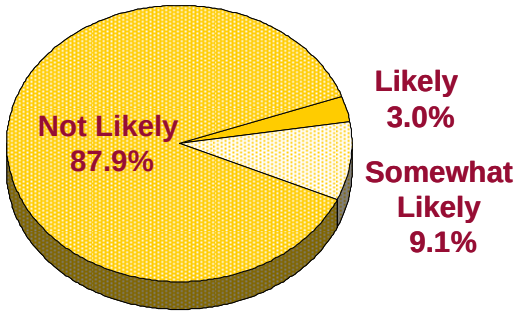
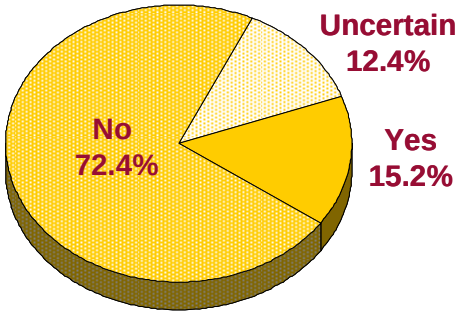


Figure 3: Hospital Contemplating Acquisition of Laboratory or Outreach Program



Overall, laboratory acquisitions are down both in number and price compared to a couple of years ago. Not that long ago, selling price was driven by high multiples, a term indicating the factor used to calculate the price by multiplying that number by revenue. For example, if a laboratory is purchased at a multiple of 2.5, that means that the selling price for the laboratory is 2.5 times its revenue. Multiples have dropped from a high of 2.5 to even 3 a few years ago to between 1 and 1.5. This in itself has resulted in fewer laboratory and outreach program sales, as organizations are reluctant to sell at such a reduced multiple. In addition, recent acquisitions have focused mainly on esoteric and anatomic pathology laboratories.

Trend #2: The Move Toward Diagnostics

Trend #2 centers around the move toward a blended diagnostic model, which represents a major, positive shift in strategy for outreach programs. Using this approach, the hospital markets and delivers multiple diagnostic services (e.g., laboratory, imaging, etc.) through an all-inclusive program, thereby bringing in a broader range of business from the community.

Chi gauged survey respondents' current shift toward this combined diagnostic outreach model. As illustrated in Figure 4, twenty-eight percent of respondents said that other diagnostic services are marketed with laboratory as part of their outreach programs. Of that 28 percent, 71 percent indicated imaging as the additional marketed service (Figure 5). From a hospital's standpoint, marketing laboratory and imaging together makes a lot of sense, as these areas are considered the two biggest revenue producers for hospitals. Combining them into one program allows the hospital to leverage existing infrastructure and leads to more business and higher margins.

Figure 4: Do You Market Other Services Along with Laboratory?

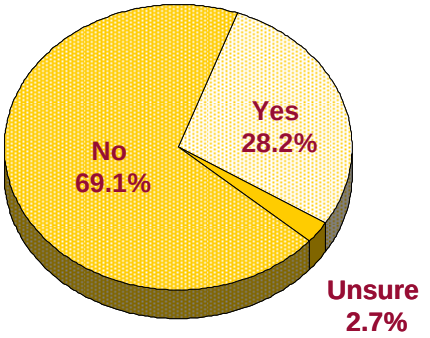


Figure 5: If Yes, Which Services?

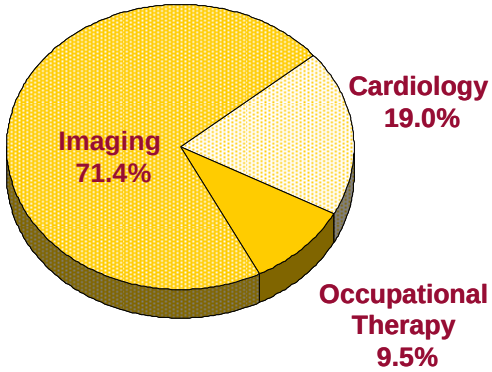
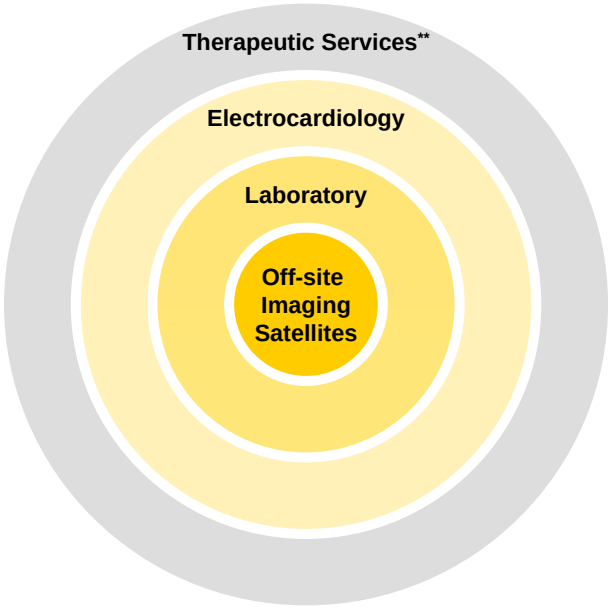


Figure 6 shows a diagnostic center model that employs the blended approach. The model can be built around an existing freestanding imaging center, as indicated by the inner circle on the figure, or developed from scratch as a broad diagnostics center. Either way, it should have imaging at the core due to the size of the equipment involved. In concentric circles around imaging, many other services come into play: laboratory, electrocardiology (e.g., EKGs, Holter monitors, etc.), and therapeutic services such as retail pharmacy, physical and occupational therapy, cancer management, etc. Several Chi clients currently employ this model to some degree, offering laboratory and imaging in a joint outreach effort with possible expansion to include other services as the opportunity arises.

Figure 6: Diagnostic Center Model*



*Built around existing/future imaging equipment.
**Pharmacy, physical therapy, occupational therapy, cancer management, etc.

The advantages of a combined diagnostic outreach program are clear from both a patient and hospital perspective (Table 3). For patients, this approach provides ease of access. Parking at a freestanding diagnostic center is often more convenient, and it is usually easier for patients to

find their way around at the center than at the hospital. Plus, diagnostic centers offer "one-stop shopping" for patients: multiple services are available in a common location.

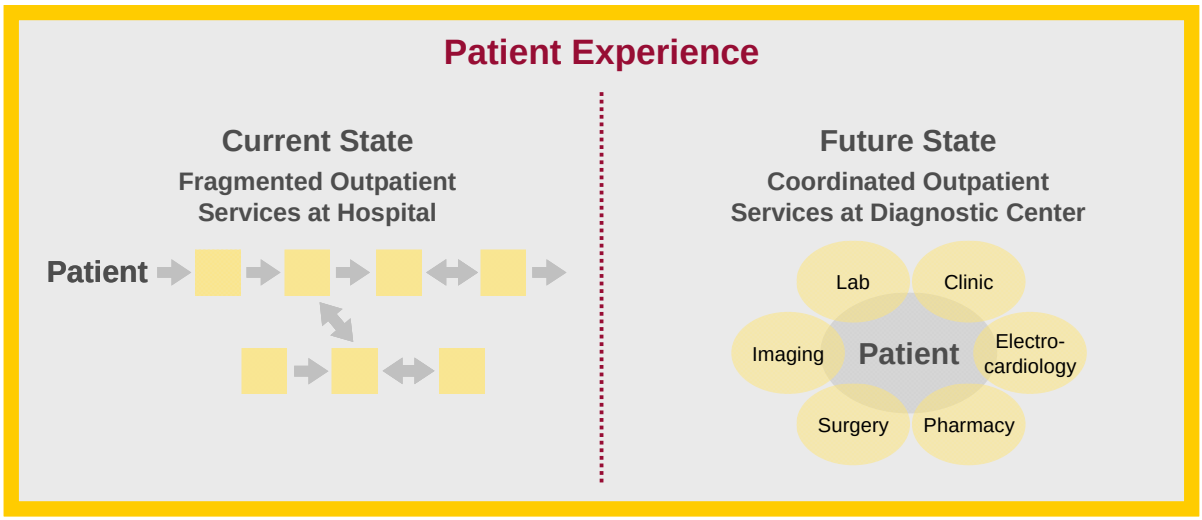
As mentioned previously, the hospital's benefit lies in leverage–it can use existing operational and sales and marketing infrastructure to broaden outreach. Salespeople can market laboratory, imaging, and other diagnostic services concurrently. Client Services and other similar aspects of the operation can be used for multiple service lines. The financial benefits to this approach are most impressive. Contribution margins for a laboratory-only outreach program typically range from 25 to 30 percent; adding imaging more than doubles the margin to 60 to 70 percent. This presents a very compelling business case for a hospital to adopt a blended outreach approach.

Table 3: Advantages of a Blended Diagnostic Approach

Patient Perspective	Hospital Perspective
Patient-centric Model	*Leverage*
1. Ease of Patient Access 2. "One-stop" Shopping	1. Marketing and Sales 2. Operations 3. Financials

The patient-friendly aspect of the diagnostic center model is underscored in Figure 7. In the current state of diagnostic services as provided at hospitals, patients encounter a fragmented process involving multiple departments that are often located in different buildings, which results in excessive backtracking and retracing of steps. The future state envisions an outpatient center with all diagnostic services in one place designed around the convenience of the patient. As a patient, which state would you rather find yourself in?

Figure 7: Outpatient Services - Current and Future States



Trend #1: The Competitive Landscape is Changing

The most important industry trend determined from Chi's survey findings is that the competitive landscape is changing. Currently, two large national laboratories, Quest and LabCorp, dwarf the competition. Over the past 20 years, these two companies have grown their business primarily through acquisition of smaller laboratories. They are now dominant in the market and fighting to claim the top spot.

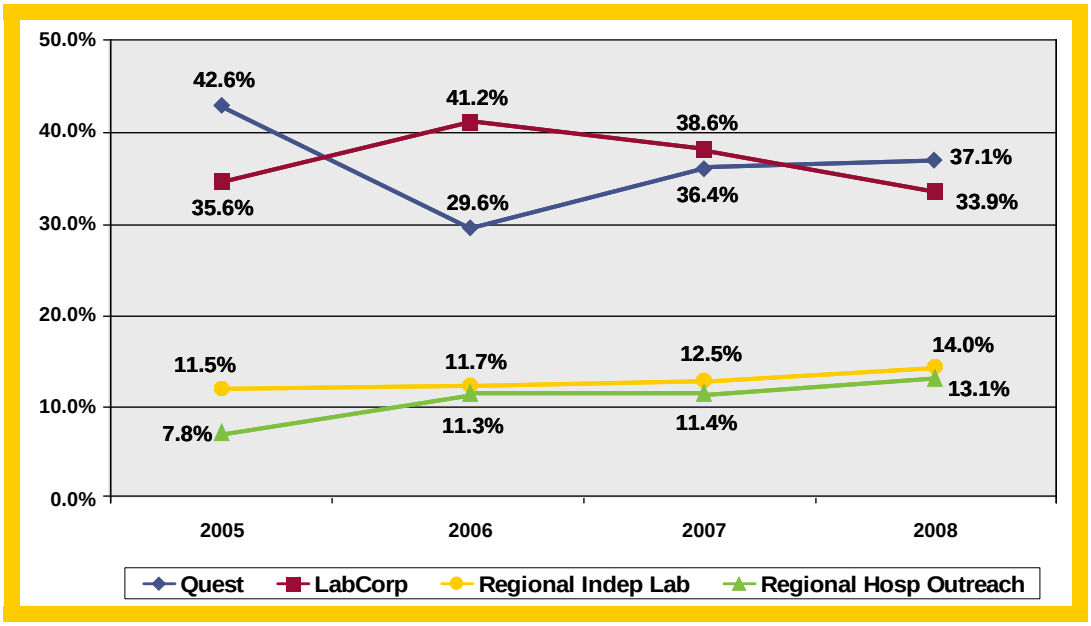
Over the years, Chi has tracked survey respondents' perception of which competitors pose the biggest threat in their markets. The first year in Table 4 below indicates Quest as the primary competitor; nearly 43 percent of 2005 survey respondents chose Quest as their main competition. LabCorp followed at 35 percent, with regional laboratories and outreach programs following at a distant third and fourth. In 2006, however, LabCorp suddenly assumed the position of top competitor (41 percent of respondents). It was during this year that LabCorp negotiated its now infamous exclusive agreement with United Healthcare. This strategy put them in first place competitvely for a couple of years, but the most recent year's numbers show that Quest has once again claimed the primary spot (37 percent). Clearly, Quest and other laboratories have found a way around LabCorp's exclusivity.

Table 4: Outreach Program Competitors (2005-2008)

Laboratory	2005 % of Total Respondents	2006 % of Total Respondents	2007 % of Total Respondents	2008 % of Total Respondents
Quest Diagnostics	42.6%	29.6%	36.4%	37.1%
LabCorp	35.6%	41.2%	38.6%	33.9%
Regional Independent Laboratory	11.5%	11.7%	12.5%	14.0%
Regional Hospital Outreach Program	7.8%	11.3%	11.4%	13.1%
Physician Group Laboratory	1.5%	1.2%	0.0%	0.9%
Other	1.0%	5.0%	1.1%	0.9%
TOTAL	100.0%	100.0%	100.0%	100.0%

Figure 8 on the next page more clearly illustrates competitor trending over the last four years of the Chi survey. It is important to note that while Quest and LabCorp remain the dominant players in the market, regional independent laboratories and hospital outreach programs are making steady gains. Survey respondents appear to be more aware of other local and regional laboratories' and outreach programs' increasing competitive presence in their markets.

Figure 8: Competitor Trends



What Does the Future Hold for Outreach?

In addition to the trends discussed above, hospital-based outreach programs could soon see the impact of current political and industry developments. It is too early to gauge the possible outcomes of proposed healthcare reform, but many believe that hospitals and physicians will begin to align more closely as a result, with more physicians employed by hospitals and health systems. Additionally, payors may contract directly with hospitals for what is referred to as a "bundled payment"–a combined payment covering the hospital stay, all procedures and tests, as well as physicians' services.

These policy shifts could have positive implications for outreach programs and deal a massive blow to the national laboratories. If doctors are employed by hospitals, and hospitals decide who provides diagnostic services, it is reasonable to assume that hospitals would choose their own outreach programs over national laboratories. National laboratories may even be forced to revert to functioning as reference laboratories to hospitals, while hospital-based outreach programs become the primary providers of community outreach testing, thereby capturing all of their local market share. It remains to be seen whether this vision of future competitive success for outreach laboratories comes to pass.