

Mergers and Acquisitions of Pathology and Clinical Laboratories

How to Prepare Your Hospital Laboratory to Maximize Its Value in a Sale or Joint Venture

Earl Buck

May 5, 2011

Purpose

Focus = Hospital laboratory and/or outreach “divestiture”

Topics to be covered:

- **Pros and cons of selling**
- **Forms of divestiture**
- **Common issues encountered**
- **Recommendations interspersed throughout this presentation**

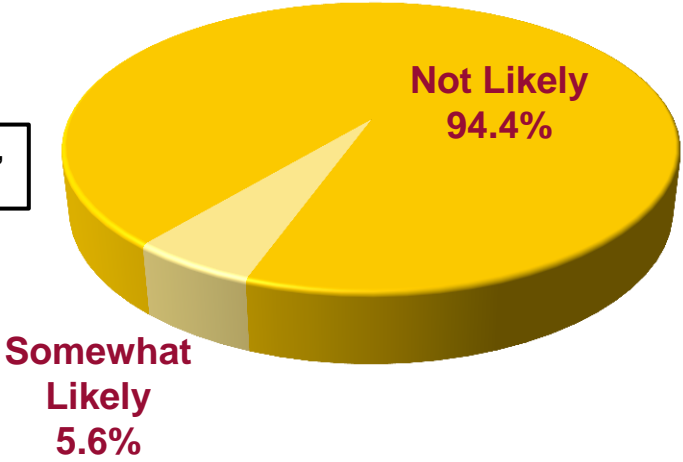
Take away will be your own list of needed actions if you are contemplating a transaction

Are Hospital Labs/Outreach of Interest?

	Yes	No	Uncertain
To your knowledge, has your hospital been approached about selling your outreach program to a national or regional competitor?	16.7%	83.3%	0.0%
Are you contemplating growth of your outreach program via acquisition of a lab or lab outreach program in your market?	14.4%	78.9%	6.7%

Likelihood of Outreach Program Sale

9th Annual Laboratory Outreach Survey, published in 2010



Note: Activity has increased in the past 12 months.

Is the Program of Sufficient Size?

PROGRAM SIZE - FISCAL YEAR 2009

Minimum

Annual Net Revenue	
Maximum	\$70,795,982
Upper Quartile	\$10,439,194
Median	\$5,584,245
Lower Quartile	\$2,443,681
Minimum	\$150,000
Average (Mean)	\$8,779,519
Standard Deviation	\$12,106,840

Annual Test Volume	
Maximum	3,374,059
Upper Quartile	670,749
Median	393,517
Lower Quartile	205,000
Minimum	5,520
Average (Mean)	597,456
Standard Deviation	723,601

Calculated Net Revenue Per Test	
Maximum	\$46.67
Upper Quartile	\$31.34
Median	\$19.45
Lower Quartile	\$12.67
Minimum	\$6.05
Average (Mean)	\$23.88
Standard Deviation	\$13.16



Attractive to buyers

Forms of Divestiture

Sale

Service

Outreach Customer List

Customer List plus Core Lab

Entire Lab Operation

To Whom

National/International Laboratory

Regional Laboratory

Private Equity

JV

Service

Core Lab and Outreach Program

Entire Lab Operation

To Whom

National Laboratory

Regional Laboratory

Private Equity

- Majority Ownership
- Recapitalization Option

Pros and Cons: Sale or Joint Venture

Pros	Cons
Cash and/or Capital	Loss of Management Control
Management Expertise – Business Focus	Loss of Local Testing/Local Market
Infrastructure/Systems Tested	Loss of Service Mgmt. – Medical Staff
Contract Pricing – Leveraged Volume	Mission Compatibility – NFP vs. FP
Lower Unit Cost – Economies of Scale	Loss of Continuum-of-Care Concept
Access to Technology	May Mandate to Manage Hospital Lab
High Interest Level in Today's Market	Non-compete in Outreach Market
JV – Keeps Hospital Engaged	Impact on Pathologists

Increasing Value: Key Components

- **Make sure you have a well-documented story of success before the sale offering is made.**
 - **Approach the sale from a factual basis and keep emotional aspects in the background.**

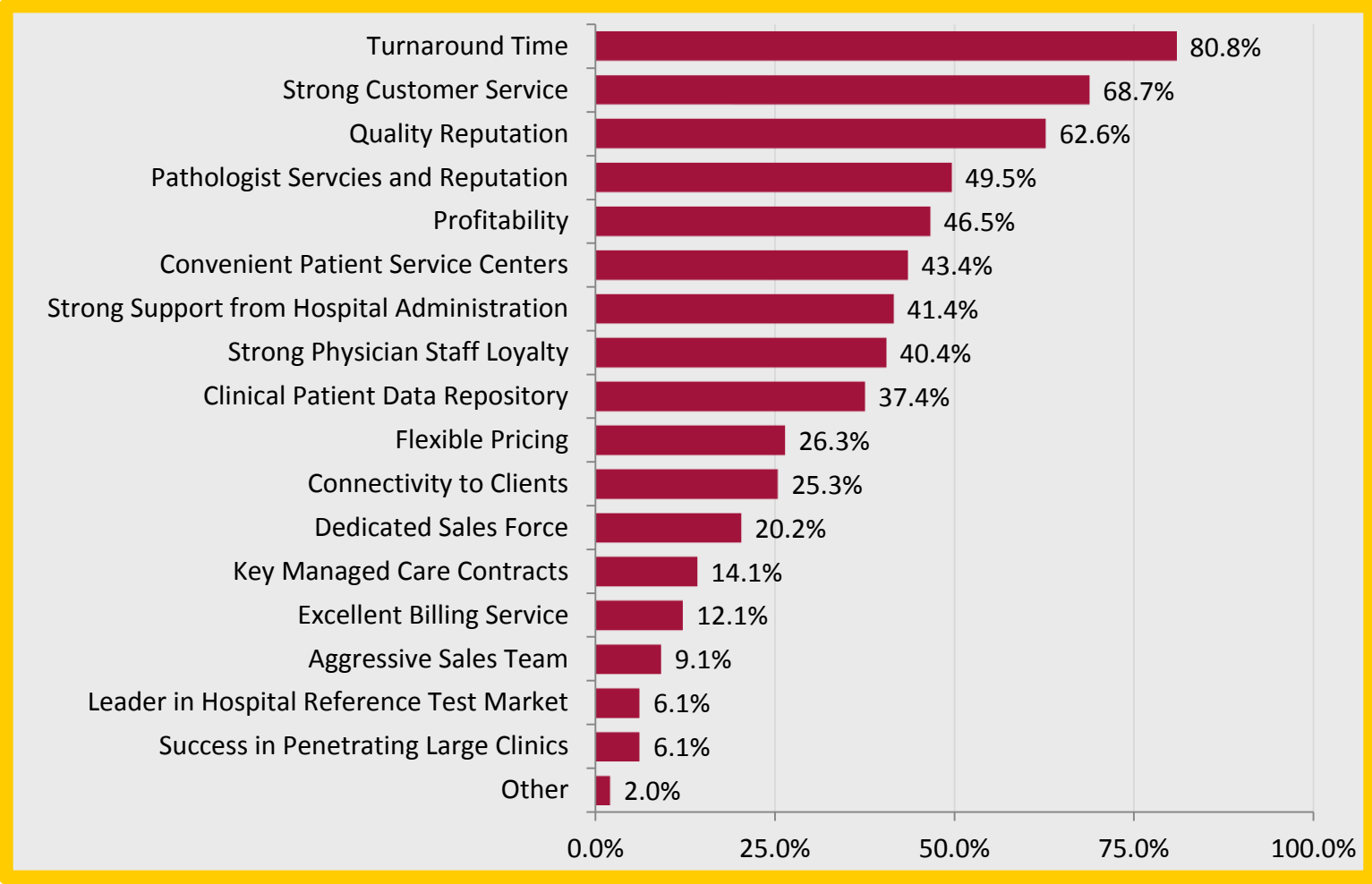
- **Value to buyer = future return/purchase price.**
 - **Future return includes positive impact to buyer's existing business (seller can't define) plus the return generated by the acquired business (seller can define).**

- **Maximize the strengths of the business and fix or eliminate the weaknesses of the business.**

- **If uncertain how to do these things, hire someone who has done it before to package the business and present the best story backed up by documentation.**

Are the Program Strengths Important to the Buyer?

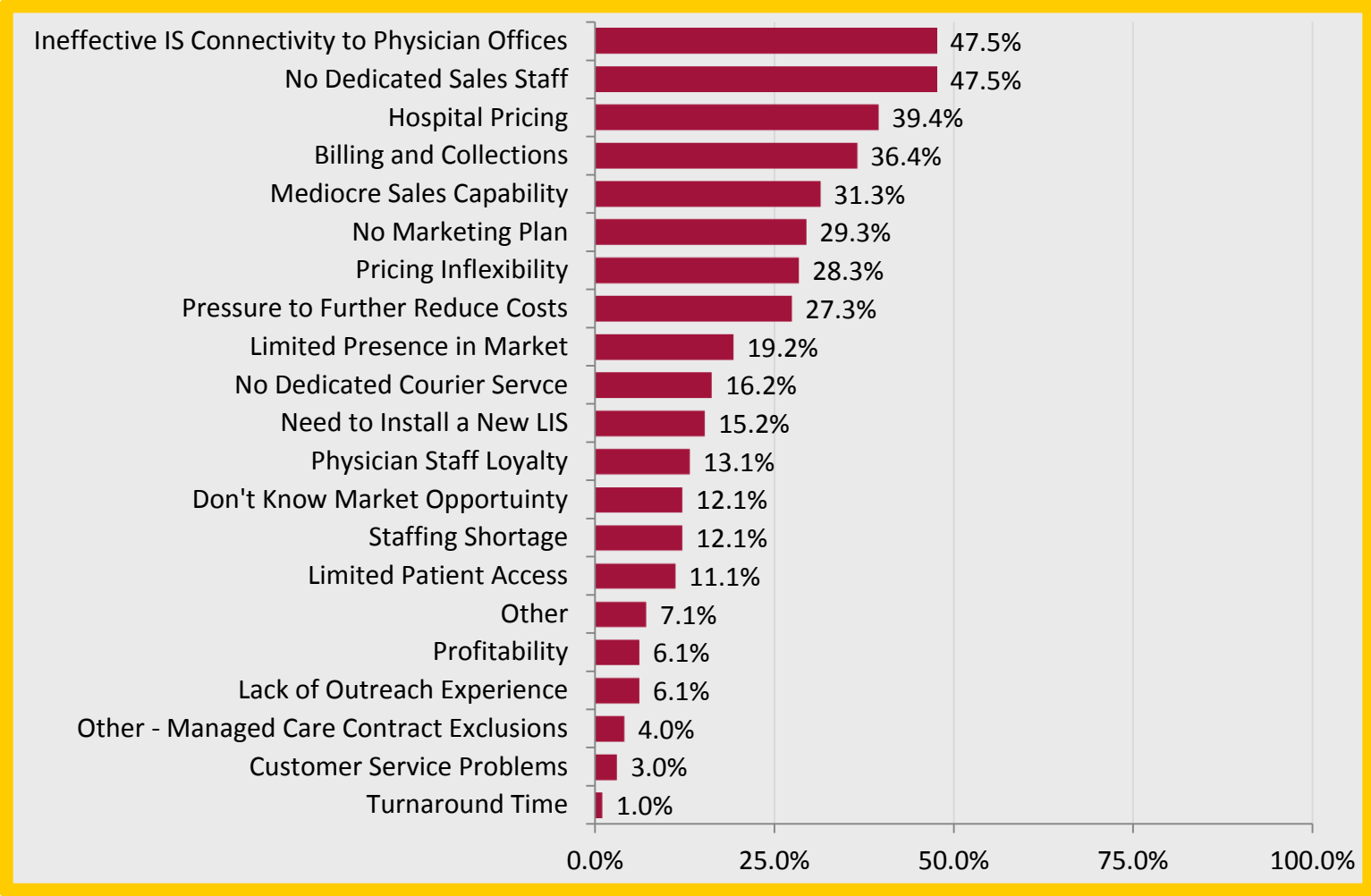
PRIMARY OUTREACH PROGRAM STRENGTHS



Many of these are, depending on the buyer and their intent regarding future site of testing, but you must be prepared to translate these into value for the prospective buyer.

Eliminating Weaknesses Creates Value

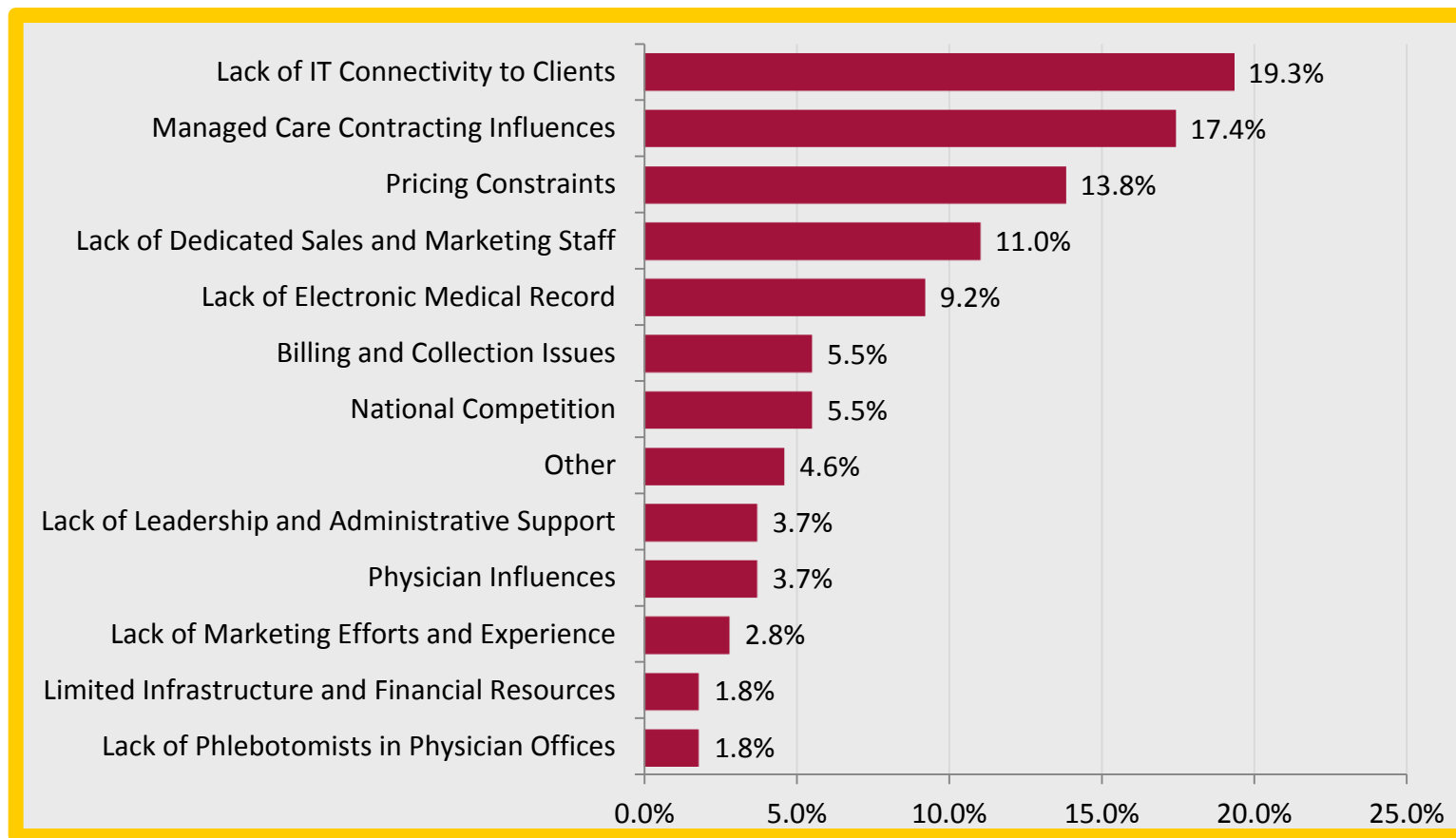
PRIMARY OUTREACH PROGRAM WEAKNESSES



**Some of these will prevent the operation from being positioned as a potential acquisition.
The more you can eliminate, the more value will be enhanced.**

If Not Competitive, the Value is Minimized

BIGGEST COMPETITIVE PROBLEMS



The biggest competitive problems for respondent outreach programs are lack of IT connectivity, managed care contracting issues, pricing constraints, lack of marketing efforts or experience, and lack of an electronic medical record.

Due Diligence Problem Areas

Organization	Trademarks and Copyrights
Employees, Benefits, HRM	Patents and Technology
Operations	Litigation
Real Estate	Environmental
Tangible Personal Property	Insurance and Risk Management
Financial and Accounting	Contracts
Taxes	IT/LIS
Regulatory Compliance	

Organizational

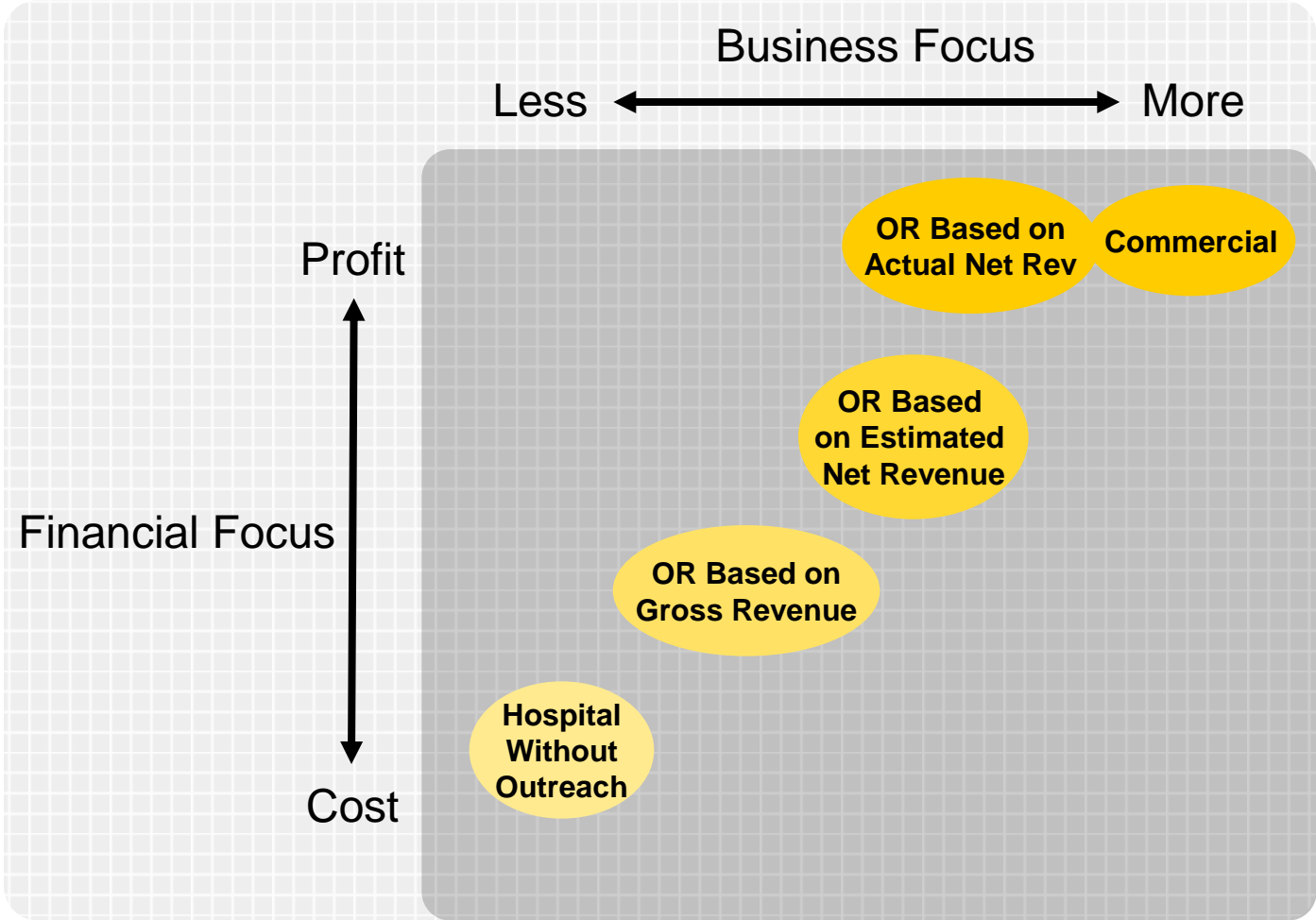
- **Only hospitals that have created independent laboratories and/or separate business structures are positioned to maximize value.**
- **Labs as revenue centers can be valued if financial performance is separately tracked and not co-mingled in the complex hospital accounting methodology.**
- **Executive leadership must be clearly defined (who will lead the negotiation), and the authority to make decisions regarding a deal must be clear with a process that can move at a reasonable speed.**
- **Asset documentation must be accurate/current (facilities, equipment, cash, accounts receivable, etc.).**

Financial and Accounting

- **Must have documentation that billing compliance programs are in place and effective (audits done, correct CPT codes in use, necessary order authorization documented, etc.).**
- **Must have accurate financial statements documenting the profitability/margin of the outreach program as a stand-alone (do documents tell a consistent story?).**
- **Must be able to document key financial performance metrics (payor mix, DSO, bad debt, etc.).**
- **Must be able to clearly document net revenue via revenue cycle management data and reports.**

How Focused Are You Regarding Profitability?

Depends on Your Perspective



If You Don't Know Your Net Revenue Or Cost, You Don't Know Your Profit

Profitability: A Key Determinant of Value

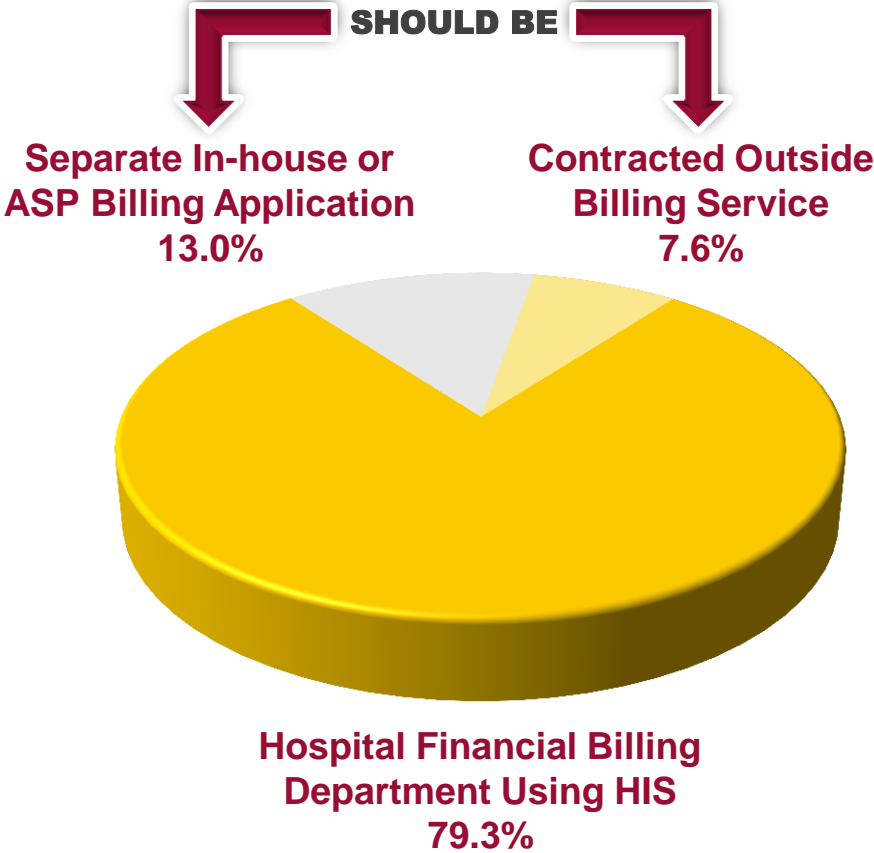
PROFITABILITY REVIEW

	Yes	No	Uncertain	
Has your outreach profitability been analyzed?	67.4%	19.6%	13.0%	✓
	Actual	Estimated	Uncertain	
Was net revenue actual or estimated?	53.8%	40.0%	6.2%	✓
	Yes	No	Uncertain	
Expenses included:				
▪ Hospital Overhead	50.8%	43.1%	6.2%	✓
▪ Laboratory Administration	73.4%	21.9%	4.7%	
▪ Outreach Support	83.1%	7.7%	9.2%	
	Average	Incremental	Uncertain	
Technical costs based on:				
▪ Average or Variable/Incremental	22.4%	60.3%	17.2%	

✓ **If a prospective buyer has to guess about the true cost of operating/owning your laboratory, the value will be diminished!**

Billing: Is Net Revenue Documented?

TYPE OF BILLING SERVICE UTILIZED



Percentage of Collections Paid to Outside Service	
Maximum	9.5%
Upper Quartile	7.4%
Median	5.3%
Lower Quartile	4.9%
Minimum	4.5%
Average (Mean)	6.4%

PROBABLY NOT

“Estimated” net revenue will reduce the value of the operation!

Billing: Is This Data Specific to Lab Outreach?

BAD DEBT AND DSO

Bad Debt Rate	
Maximum	11.0%
Upper Quartile	7.3%
Median	4.0%
Lower Quartile	2.4%
Minimum	1.0%
Average (Mean)	5.0%

Days Sales Outstanding (DSO)	
Maximum	110
Upper Quartile	49
Median	41
Lower Quartile	32
Minimum	26
Average (Mean)	45

Know the Bad Debt Rate 27.3%
Don't Know 72.7% ✓

Know the DSO 29.4%
Don't Know 70.6% ✓

✓ Any data or lack of data that challenges the credibility of reported revenue will diminish the value of the business!

Regulatory Compliance

- **Significant CAP or CLIA deficiencies in the recent past can impact the comfort level of the buyer/partner.**
- **Stark Law implications will always be a focus during the due diligence process—review this before the offering.**
- **Billing compliance has been mentioned previously, but merits reinforcement again here.**
- **Tax compliance, whether it be typical business tax filings or unrelated business tax filings, demonstrates the level of sophistication of management practice and can build or destroy trust with the buyer/partner.**

Risk Management

- **Any regulatory compliance issue will translate into a risk management concern.**
- **History of “switched specimens,” especially in anatomic pathology, causes great concern on the part of buyers (one firm reports this was an issue in five different transactions in the past 18 months)—P/P in place and demonstration that it is followed.**
- **The number of pending significant quality failures will impact the terms of the deal.**

Contracts – Purchasing and Service

- **For too many operations, complete files are not well maintained to document contracts:**
 - **Contract currently in effect (sometimes expired).**
 - **Copy of dated, executed contract.**
 - **Current pricing that applies to the contract.**
 - **Impact of a change in ownership or control.**
 - **Unable to satisfy due diligence requests.**
- **Payor contracts may also be a point of interest if an ongoing obligation rests with the lab operation.**

LIS and IT Systems

- **LIS that is not current and effective will reduce value.**
- **LIS that cannot support lab as a freestanding IT product can be a negative, to include the staff to support the product.**
- **Existing interfaces to providers and the ability to create interfaces are viewed as valuable benefits by today's buyers.**
- **Business systems (e.g., billing, CRM, scanning, sales tracking, etc.) can add value to the business.**

Other Categories

- **Presence of a union will eliminate some labs from consideration by some buyers.**
- **Inability to have the management resource/knowledge to respond to due diligence requests in a timely manner will be a negative.**
- **Loss of market share or a negative trend in financial performance will have a negative impact on value.**
- **Lack of adequate preparation prior to the sale offering can lead to significant “surprises” that can sometimes derail a negotiation.**
- **Ability to disclose all aspects of the operation and document the same is a real plus.**

Summary Recommendations

- **Educate yourself regarding options available and understand the valuation of your business—be realistic in expectations.**
- **Know what you are willing to do and not willing to do regarding a deal and who you are willing to consider as a buyer or partner.**
- **Net revenue and the customer list must be clearly documented, with asset detail also important.**
- **The more you can present the operation as a well-run business (vs. an excellent clinical service), the higher the value.**
- **Understand the impact of a sale/JV on future lab services to inpatients/outpatients and your medical staff.**
- **Ask for help—do not go it alone!**

Great ideas Are
ONE THING.

A GREAT OUTCOME
IS OUR THING.

Earl Buck
Chief Operating Officer
(734) 662-6363 x471
ebuck@chisolutionsinc.com

