Your Independent Source for Business & Financial News

G2 INTELLIGENCE

# LABORATORY INDUSTRY REPORT™

Vol. 13, Iss. 21, November 7, 2013

HIGHLIGHTS



www.G2Intelligence.com



## Sonora Quest CEO Discusses the Role of Labs in ACOs

As Dave Dexter sees it, laboratories will have to be aggressive in order to assume an appropriate role in accountable care organizations (ACOs).

That was the message Dexter, chief executive officer of the Arizona-based Sonora Quest Laboratories, communicated at last month's G2 Intelligence Lab Institute in Arlington, Va.

Dexter noted that while the ACO Sonora Quest participates in via hospital operator Banner Health has been successful—hospital admissions have been reduced 9 percent and average length of stay has been cut 14.4 percent, saving millions of dollars—he believes the cost pressures on labs are out of line relative to the value they deliver.

According to Dexter, labs serve as an "enabler" to lower health care costs. "We're not the cost problem in health care. We're not even remotely close to it," he said.

*Continued on page 2*

## Three Quick Deals in October May Signal Resurgence of Laboratory M&A

Could there be a trickle in the currently dammed-up world of laboratory mergers and acquisitions?

That question floated around after three high-level deals occurred within days of each other last month.

Industry giant Quest Diagnostics acquired Peabody, Mass.-based ConVerge Diagnostics from Water Street Healthcare Partners, a strategic investor firm in Chicago. Days later, Water Street sold its other laboratory—Irvine, Calif.-based PLUS Diagnostics—to Miraca Life Sciences, based in Irving, Texas.

"We expect to be able to extend our world-class pathology services to a broader base of physicians and patients thanks to this transaction," said Frank Basile, M.D., Miraca's chief executive officer.

The third deal involved New Jersey-based Spectra Laboratories acquiring Shiel Medical Laboratory, which has significant operations in New York City.

The flurry of transactions occurred after a year in which there has been a significant drop in volume. One notable acquisition-focused player, Regional Diagnostic Laboratories, all but dropped out from

*Continued on page 7*

■ **Sonora Quest CEO Discusses the Role of Labs in ACOs**, *from page 1*

He believes that Arizona, one of the few red states to expand its Medicaid program under the Affordable Care Act, will have about 500,000 newly insured residents in the coming years (300,000 Medicaid enrollees and 200,000 who will purchase commercial coverage via the state's health insurance exchange). Although they could be seen as a new revenue stream, they will be entering a care system that is being reshaped by the ACA.

Various components of health care reform will push many other changes in the way health care is delivered, particularly in the greater use of electronic health records (EHRs), chronic disease management, and coordinated, patient-centric care. The fact that most providers now use EHRs is why Dexter believes ACOs will be much more successful than their predecessors from the 1990s, the physician-hospital organization.

Dexter also believes that the nexus of ACOs—the hospitals and medical groups—see laboratories as a data partner as opposed to a testing vendor, primarily due to the transparency and portability of the patient health records. And even if the Affordable Care Act itself does not prove entirely successful, the bundled payments and value-based care that delineates ACO operation are here to stay.

However, since labs are being asked to take reductions in reimbursement out of line to the value they deliver, Dexter believes labs are going to have to fight hard to insert themselves into the ACO equation. That's primarily because labs have a small footprint in the overall care delivery equation.

"Value is someone's perception until you make it a reality for them. We're going to have to do that . . . even though it's unfortunate we're going to have to continually fight this battle," he said.

***Takeaway: If laboratories wish to be successful within an ACO environment, they will have to advocate their value to those running such organizations.*** G2

## Enzo Biochem Narrows Loss, Focus on Diagnostics

Enzo Biochem reported a marginal increase in revenues and a dramatically recuced loss for fiscal 2013, as it continues to narrow its business focus to esoteric testing.

The New York-based firm reported a net loss for the fiscal fourth quarter, ending July 31, of $3.1 million on revenue of $23.3 million. Although revenue was down more than 13 percent compared to the $26.4 million reported for the fourth quarter of fiscal 2012, it beat the consensus of analysts, which had projected $22 million. The company's loss was also down dramatically, to $3.1 million from $27.1 million.

For fiscal 2013, Enzo reported a net loss of $18.2 million on revenue of $93.7 million. In fiscal 2012, it lost $39 million on revenue of $103.1 million.

Clinical laboratory operations are the largest component of Enzo's business, comprising $14 million in revenue for the fiscal fourth quarter and $55.9 million for the fiscal year, or about 60 percent of the total. In 2012, it comprised about 57 percent of total revenue.

 

"Much of what we have accomplished in fiscal 2013 has been geared towards positioning Enzo Biochem towards capitalizing on its strong intellectual property portfolio through commercialization of diagnostic technology and products," said company president Barry Weiner. He also observed that the company's long-term focus, "in addition to improving productivity and reducing overhead, has been to move increasingly to higher-end esoteric diagnostics through both collaboration and in-house developments, a strategy that is reflected in the unit's positive cash flow in the fourth quarter."

Provisions for uncollectible accounts were also reduced by 59 percent in the fourth quarter compared to a year ago, and 35 percent compared to the third quarter of fiscal 2013.

Shortly after reporting earnings, Enzo announced that it has entered into an agreement to market Sequenom's MaterniT21 PLUS test in the northeastern United States. It also announced a collaboration with an Italian company, DiaSorin, to use some of its proprietary diagnostic tools for lab results.

One firm that follows the company, Jefferson Research, upgraded its rating of Enzo from hold to buy not long after the earnings report was released.

*Takeaway: Enzo Biochem's focus on diagnostic services could begin to pay dividends in the near future.*

## Community Labs Face Serious Challenges in Coming Years

Can a community lab succeed in today's environment? Perhaps not, observed Richard Nicholson, chief executive officer of West Pacific Medical Laboratory, at last month's G2 Intelligence Lab Institute.

"A community lab like ours has probably a three- to maybe a 10-year life span," he said. Although West Pacific has grown dramatically since its founding, Nicholson believes that the competition with large labs in a large metropolitan region is a challenge, particularly with pricing continuing to go down and industry giants such as Quest Diagnostics taking the time and money to redesign their draw stations solely to make a stronger brand statement.

Labs are also being asked to pick up extra costs, such as paying to electronically connect with other providers—Nicholson estimated his lab has spent about $300,000 to do so.

As a remedy, community labs have to be able to assert a strong presence and avoid competing on price. "You have to be strong in your market, and not just be picking up specimens from doctors' offices in a wide area," Nicholson said. And since community labs cannot compete with large labs on benefits, they have to be more willing to obtain input from their employees.

Nicholson also recommended having strong accounts management: If a payer is cutting reimbursement by $5, your lab should be cutting expenses by the same amount. Labs also should offer a discount for self-pay patients who pay at the time of service and should have cash reserves on hand if there is a technical glitch with a large payer that hinders cash flow.

*Takeway: Community labs have to be creative and flexible in order to compete with large players.*

  

## NeoGenomics' Financial Success Achieved With Microscopic Attention to Detail

Baseball is a game of inches. And as NeoGenomics Laboratories Chief Executive Officer Douglas VanOort discussed during G2 Intelligence's Lab Institute in Arlington, Va., last month, his operational challenges are often a matter of feet.

In one example, it was 540 feet. That is how much distance was cut from what the company's flow cytometry lab technicians had to traverse on average to process a test.

"Would you rather walk 600 feet or 60 feet to do the exact same job?" VanOort asked during an interview following conference.

Such a redesign—NeoGenomics operates flow cytometry sites at both its Fort Myers, Fla., headquarters and in Irvine, Calif.—occurred over the course of a single weekend. And it was performed by a lab chief whom VanOort recalled was puffing his chest out with pride about already running the best such facility in the country.

> ***"It sounds simple, but when our people work to improve processes collaboratively, good things happen."***
> ***—Douglas VanOort, Chief Executive Officer, NeoGenomics Laboratories***

That chief had been invited to one of the half-dozen *kaizen* sessions the company conducts every year. Adopted from the Japanese process used to improve operations, they are two- to three-day closed-door sessions with managers, technicians, and other personnel to determine how to hone NeoGenomics' processes to a point where all the excess costs have been wrung out and every possible efficiency has been introduced.

The travel reduction also contributed to another impressive statistic: NeoGenomics was able to process 20 percent more tests in the third quarter of 2013 versus the same quarter a year ago, with only a commensurate 5 percent increase in costs and staffing.

VanOort cited another example: NeoGenomics' employees in Florida were spending about 40 minutes every day packing specimens to ship to its California lab. Not only were the California employees unhappy with the way the boxes were being packed, it was costing them time. A kaizen session led to a box-packing protocol that not only made both sets of employees happy, it made the entire process faster and more efficient.

"It sounds simple, but when our people work to improve processes collaboratively, good things happen," VanOort said.

### Tremendous Growth

The numbers tend to bear out that VanOort's tenure as NeoGenomics' chief executive officer has been productive not only in terms of feet traveled but

  

also in the emergence of good things. When he took over the molecular testing company in 2009, revenue was less than $30 million a year and it was losing money. It is now on track to end 2013 with revenues approaching $65 million, with net income recently entering the seven figures.

In addition to the revenue growth, NeoGenomics' product offerings continue to expand at a rapid pace, with about 80 new tests introduced in the past 18 months. The company is also seeking to release in 2014 a prostate cancer test that relies on a urine sample rather than a tissue biopsy, something that discourages many patients from seeking crucial follow-up tests.

| NeoGenomics Laboratories Earnings | | | |
|---|---|---|---|
| **3Q 2013 Revenue** | **3Q 2012 Revenue** | **3Q 2013 Net Income** | **3Q 2012 Net Income** |
| $16.9 million | $14.2 million | $900,000 | $975,000 |
| **Year-to-Date 2013 Revenue** | **YTD 2012 Revenue** | **YTD 2013 Net Income** | **YTD 2012 Net Income** |
| $48.1 million | $45 million | $1.18 million | $178,000 |
| *Sources: Financial Reports* | | | |

But every single penny of NeoGenomics' growth appears to have been ground out with all the accompanying tension of a baseball championship game. Although its repertoire focuses on high-cost molecular tests used to aid cancer and other esoteric diagnoses, the average revenue NeoGenomics reaps per assay has dropped 21 percent over the past three years. Its tests retail for a median of about $500, on the lower end for a segment where some tests can command thousands of dollars.

Yet despite the financial pressures, the average cost for each test NeoGenomics performs has been driven down 34 percent in the past three years. And its gross profit margin has increased to 48 percent in the third quarter of the year, compared to 41 percent during the third quarter of 2012.

**Using Large-Business Experience**

To succeed in such a difficult environment, the 57-year-old VanOort relies on the experience he has gained at both larger and smaller businesses. Beginning in the early 1980s, he served in a variety of positions at Corning Life Sciences, eventually becoming its chief financial officer. The company was spun off to become Quest Diagnostics, where he served as senior vice president of operations before leaving in the late 1990s to found a venture capital firm.

Along with running NeoGenomics, VanOort has longtime experience in the retail space: He has co-owned 11 Ace Hardware stores in the Central Florida area for the past decade and a half.

  

"Although that is a very different business, there is a common thought process and approach," he said. "Each company uses a management process built around a unique mission, vision, values, key success factors, and objectives. Each company is obsessively focused on customer service. Each company works hard to constantly improve its key processes. And each company believes that its employees are its most important asset."

And VanOort also believes smaller businesses provide more of an opportunity to make an impact.

"Large companies have important strengths and can be great training grounds for people. But in a big company, it's sometimes hard to make a difference," he said. "You can really make a difference in a small company. And well-run small companies can leverage many of [the] same strengths as larger companies."

**Employee Morale**

But imposing large-scale efficiencies on a smaller firm such as NeoGenomics is a risky proposition: Morale can take a beating if employees believe they are merely a cog in an operational process. VanOort noted that focus is placed not only on the core competencies of the workforce but also in encouraging four specific values: quality, accountability, integrity, and teamwork.

Those employees who embrace those values are regularly recognized, and they are encouraged to praise one another on electronic bulletin boards visible to all of the workforce. These kudos are part of a point system that can be redeemed for gifts. Employees are also encouraged to nominate one another for quarterly core value awards. Presentations are made during companywide meetings.

***"We believe that a sales team's ability to close business is directly related to how they demonstrate the NeoGenomics culture."***
***—Douglas VanOort***

The sales staff, which has grown from 18 to 23 in the past year, is also very carefully selected and trained. Biweekly seminars are held in order to educate them about the utility and significance of current and recently developed assays. Pathologists, medical practices, and other clients are also continuously informed of new and ongoing product lines through e-mail blasts, webinars, and other forms of communication.

"We believe that a sales team's ability to close business is directly related to how they demonstrate the NeoGenomics culture," VanOort said. By combining that with relentless attention to customer service, he noted that very few clients turn over once their business has been retained.

"We have to do 100 things right all the time in order to maintain good service," VanOort said. But that and the extreme focus on productivity and cost control have made the difference in being able to grow NeoGenomics while encountering some very tough headwinds.

*Takeaway: Even in a difficult operating environment, labs can grow if they focus on service, efficiency, and cost control while promoting a positive corporate culture.* G2

  

■ **Three Quick Deals in October May Signal Resurgence of Laboratory M&A**, *from page 1*

making deals because its management said there were none to be had. That seemed to portend an arid M&A climate: Regional had been staked with $250 million from Warburg Pincus specifically to snap up labs.

According to data from Haverford Healthcare Advisors, just 23 deals were consummated in 2012, about one-third less than in 2011. There were only three in the first quarter of this year.

**ACA Prompting Deals**

Web site problems aside, the rollout of the Affordable Care Act is prompting more deals throughout the health care sector, laboratories included.

"The health care M&A markets, including laboratory and related diagnostic niche sectors, are seeing robust activity and increasing numbers of closed transactions," said Jonathan Sadock, managing partner and chief executive of Paragon Ventures, a Wayne, Pa.-based firm that helps negotiate health care transactions. "Corporate buyers and strategic private equity firms are actively pursuing both platform and accretive acquisitions as evidenced by Spectra Labs' acquisition and several of Water Street's recent portfolio exits."

Sadock added that he expects a heightened level of activity to continue through 2014 as it becomes clearer how many more Americans will wind up being insured as the result of the ACA.

That Water Street shed its two labs within a few days of each was completely coincidental, according to company vice president Kelly Zitlow. "It really was part of our long-term strategy to grow both companies and our goal was to sell them to leaders in our space," she said.

Zitlow added that communications with potential buyers had been ongoing while the labs' business was being grown. Water Street had been overseeing PLUS's operations since 2006 and ConVerge's since 2009.

We're very pleased with the outcome. . . . [B]oth companies are now with leading industry organizations, [and] we achieved a strong return for our investors," Zitlow said.

Neither acquisition will add significantly to the bottom lines of their buyers—at least not immediately. Stock analyst firm Zacks noted that the ConVerge deal will be neutral to Quest's earnings this year, and expects it to be "modestly accretive" to adjusted earnings in 2014.

However, Zacks noted that the acquisition "is expected to synergize perfectly with the Quest Diagnostic[s'] business portfolio. The acquisition will extend the range of diagnostic information services for [Quest], facilitating greater accessibility of patients in the region and enhancing better patient outcomes in the long-run."

Kevin Ellich and Bradley Maiers, analysts for Piper Jaffray, noted that ConVerge will operate as a Quest subsidiary for the time being but will eventually be integrated into the large lab Quest is currently building in Marlborough, Mass., 40 miles west of ConVerge's current corporate headquarters.

***Takeaway: A recent flurry of deals in the laboratory sector could signal a resumption of merger and acquisitions.*** G2

  

INDUSTRY BUZZ

# New Lab Venture Is Direct Descendant of deCODE Genetics

Icelandic firm deCODE Genetics will expand its offerings to the clinical laboratory setting in the United States through a spinoff company backed by several venture capital firms.

Known as NextCODE Health, the new company is based in Cambridge, Mass., and is operating a CLIA-certified laboratory. It is funded with $15 million in series A venture capital from Polaris Partners and ARCH Venture Partners.

deCODE Genetics has the technological chops to predict the genetic susceptibility in individuals of more than 40 medical conditions, including heart attacks and adult-onset diabetes, which are big cost-drivers for the U.S. population.

But deCODE has had a bumpy history since its founding in the mid-1990s. To date it has offered a single genetic test—an assay priced far higher than comparative offerings in the United States. It filed for bankruptcy in 2009 and was purchased by a consortium of venture capital firms for $14 million. Drug giant Amgen acquired deCODE last year for $415 million. The deal was financed primarily with offshore cash in order to avoid U.S. regulatory review but likely makes it difficult for deCODE to directly service the American market.

High-ranking former deCODE Genetics executives are running NextCODE Health. Hannes Smarason, who served as deCODE Genetics' chief financial officer between 1997 and 2004, is now NextCODE's chief executive officer. Jeff Gulcher, M.D., deCODE's co-founder and chief scientific officer, is serving as president and chief scientific officer.

"Our vision is to transform patient diagnosis and resultant care through the rapid and accurate use of genome sequence data, and we are deploying the most powerful tools ever developed to make this vision a reality," Smarason said. "These tools will enable us to provide clinically relevant insights to physicians and geneticists with unrivaled speed and accuracy. We are proud to build on deCODE's legacy of discovery as we deliver capabilities needed to meet the urgent needs of patients and physicians today."

NextCODE has struck a research initiative in oncology and pediatrics with Boston Children's Hospital and universities in Europe, Australia, and Asia.

***Takeaway: The reshaping of deCODE Genetics into a new venture may finally pay dividends.***

## *References*

ARCH Venture Partners
773-380-6600

Banner Health
602-747-4000

ConVerge Diagnostics
800-618-9992

Miraca Life Sciences
800-979-8292

NeoGenomics Laboratories
866-776-5907

Polaris Partners
855-787-3500

Quest Diagnostics
973-520-2700

Sonora Quest Laboratories
602-685-5000

Water Street Healthcare Partners
312-506-2900

**Note our change of address and phone numbers effective immediately.**
**To subscribe or renew *LIR*, call now +1-603-357-8101, 800-531-1026**
(AAB and NILA members qualify for a special discount, Offer code: LIRNI1)

**Online:** www.G2Intelligence.com/LIR
**Email:** customerservice@G2Intelligence.com
**Mail to:** G2 Intelligence
24 Railroad Street
Keene, NH 03431-3744 USA
**Fax:** +1-603-357-8111

*Multi-User/Multi-Location Pricing?*
*Please email jping@G2Intelligence.com or call 603-357-8160.*

**LIR 11/13a**

**November 7, 2013**

**www.G2Intelligence.com**

 *Laboratory Industry Report* (ISSN 1060-5118) is published by G2 Intelligence, 24 Railroad Street, Keene, NH 03431-3744 USA. Tel: 800-531-1026. Fax: +1-603-357-8111. Web site: www.G2Intelligence.com.

Kimberly Scott, Managing Editor, kscott@G2Intelligence.com; Ron Shinkman, Editor; Heather Lancey, Designer; Beth Butler, Marketing Director; Dan Houder, President and Publisher

***Receiving duplicate issues? Have a billing question? Need to have your renewal dates coordinated? We'd be glad to help you. Call customer service at +1-603-357-8101.***