



Your Independent Source for Business & Financial News

LABORATORY

INDUSTRY REPORT™

Vol. 14, Iss. 3 February 3, 2014



HIGHLIGHTS

TOP OF THE NEWS

- Aurora at a crossroads: looking to grow or change..... 1
- Quest acquires Solstas Lab Partners for \$570 million 1
- Sequenom enters deal to distribute macular degeneration test..... 2
- LabCorp signs long-term pact with Illumina 3

INSIDE THE LAB INDUSTRY

- Ailing domestically, Quest Diagnostics makes major move in India 4

INDUSTRY BUZZ

- Johnson & Johnson selling off diagnostics business 8

www.G2Intelligence.com

Aurora at a Crossroads: Looking to Grow or Change

Aurora Diagnostics, the Florida-based pathology laboratory with national aspirations, is eyeing its options as its revenue base has eroded over the past year.

The company confirmed that it has retained investment banking firm Evercore Partners to assist in a potential restructuring or acquisitions. "Like all pathology lab companies, we have been affected by the recent reimbursement reductions by the Centers for Medicare and Medicaid Services," said Aurora Executive Vice President Bruce Walton. "Our executives have discussed it candidly in our regular financial reports and investor calls."

Aurora is owned by the Boston-based growth equity firm Summit Partners. It has about 115 pathologists and more than 900 nonphysician employees. It performed some 2.1 million accessions last year.

According to a recent filing with the Securities and Exchange Commission (SEC), Aurora posted revenue for the third quarter, ending Sept. 30, of \$62.1 million, a 10.5 percent drop compared to the year-ago quarter. For the first nine months of the year, revenue was down more than \$25

Continued on page 2



Upcoming Events

Pathology Institute 2014

Feb. 28 - March 1, 2014

Loews Portofino Bay Hotel at Universal Orlando®

www.G2Path.com

Becoming a Value-Driven Lab: Innovative Models and Winning Strategies

April 10, 2014

Hyatt Regency O'Hare Rosemont, Ill.

www.G2Intelligence.com/ValueDrivenLab

In One of Largest Deals in Recent Years, Quest Acquires Solstas Lab Partners for \$570 Million

Looking to bolster revenue that has not moved upward since 2011, Quest Diagnostics has shelled out \$570 million to acquire Solstas Laboratory Partners.

The deal, announced earlier this month, is the largest of 2014 so far and likely eclipsed any deal that was consummated in 2013, for which there was little data in terms of purchase prices.

The biggest similar deal with an actual purchase price attached took place in August 2012, when LabCorp acquired MedTox Scientific for \$241 million.

Solstas, a large regional player that operates in nine states in the Southeast, including Virginia and Georgia, is owned by private equity firm Welsh, Carson, Anderson, and Stowe. It acquired Spectrum Labs in 2010, then merged it with Carilion Labs to create Solstas.

Continued on page 7

■ AURORA AT A CROSSROADS: LOOKING TO GROW OR CHANGE, *from page 1*

million, a drop of nearly 12 percent. And while the company posted a modest operating profit in the quarter, it still posted a net loss of nearly \$3.5 million.

Altogether, Aurora reported only \$2.3 million cash on hand, down from \$10.8 million at the end of 2012. And despite the dip in revenue, accounts receivable were up \$1.3 million to \$30.9 million at the end of the quarter, suggesting some slowing of collectables. Its interest payments for the first nine months of the year were \$24.4 million, or about 13 percent of revenues.

The company acknowledged in the SEC filing that business conditions have had a significant impact on free cash flow and that it may be taking significant impairment charges in the fourth quarter. It took a \$114.5 million impairment charge in 2012, also related to what company officials called a difficult business climate.

As a result of the current business environment, Walton said the company was exploring acquiring other pathology practices, saying it has the capital to do so. It has also expanded its sales staff.

Michael Snyder, president of Clinical Lab Business Solutions, a New York-area consulting firm, noted that the reductions in reimbursement to labs from the Medicare program and commercial payers should not have hit Aurora any worse than any other company operating in the same space.

"Their debt seems to be a large issue," Snyder said. He added that their management should be scrutinized for allowing indebtedness to reach such a high level. That outside help has been retained is not a surprise, according to Snyder.

"Sounds like a case of when everything goes wrong in a really tough industry," he said.

Takeaway: Aurora Diagnostics' seeking outside help is emblematic of the collateral damage from eroding reimbursements in the lab sector. 

Sequenom Enters Deal to Distribute Macular Degeneration Test

San Diego-based Sequenom has entered into an agreement with a French pharmaceutical firm to distribute and market its new test for age-related macular degeneration (AMD) in the United States.

Under the terms of the pact, a firm called Nicox will distribute the test and associated reagents to ophthalmologists in the United States, Canada, and Mexico. Sequenom will perform the analysis and issue the results.

Nicox, which is based in France but has U.S. operations headquartered in New Jersey, already markets and distributes two other eye-related tests in the United States for the detection of conjunctivitis and Sjogren's Syndrome, an autoimmune syndrome that affects the tear ducts.

Sequenom's test, known as RetnaGene, can be performed using a swab from a patient's cheek. The assay analyzes a small number of genes that are responsible for about 70 percent of those who contract the disease and predict its progression.

"We are confident in Nicox's ability to leverage its growing sales team and expertise in the ophthalmic arena to successfully market the test," said Sequenom President William Welch.

Macular degeneration affects about 15 million in the United States, most of whom are the age of 60 or older. The “wet” version of the disease—which includes blood vessel leakage in the retinal area—can lead to permanent vision loss, particularly central vision. The RetnaGene test can assess disease progression and risk at two, five, and 10 years after an initial diagnosis.

“The ability to identify those patients most at risk of progressing to wet AMD represents a major opportunity to optimize the management of their disease,” said Jerry St. Peter, Nicox’s executive vice president and general manager. “We are delighted to have formed this agreement with Sequenom Laboratories to market the RetnaGene AMD test, which fits perfectly within our diagnostics portfolio, and potentially other novel genetic tests in the future.”

Takeaway: A global firm can sometimes be the ideal distributor for a laboratory test in the United States as evidenced by Sequenom’s deal with Nicox. 

LabCorp Signs Long-Term Pact With Illumina

Illumina, the San Diego-based sequencing equipment company, has signed a multiyear pact with LabCorp to provide the North Carolina-based national laboratory with its latest sequencing and microarray equipment.

The deal was announced not long after LabCorp’s biggest competitor, Quest Diagnostics, entered into similar deals with Illumina and another California firm, Life Technologies Corp. It widens an existing agreement that allows LabCorp access to Illumina’s next-generation sequencing platform and related supplies.

LabCorp has been using the technology to develop tests based on recently discovered human leukocyte antigens, which are used for tissue typing in bone marrow and related transplants.

“The Illumina next-generation sequencing platform gives LabCorp the flexibility to develop a wide range of molecular tests,” said Mark Brecher, M.D., LabCorp’s chief medical officer. “The HLA typing assays we are developing on Illumina’s family of NGS platforms will provide physicians with the ability to more accurately match bone marrow donors to recipients.”

Financial terms of the deal were not disclosed.

“The agreement seems to be in tandem with Illumina’s mission to enhance cancer research and treatments by expanding the use of the NGS platform,” Zacks said in a recent research report. “We are optimistic about Illumina’s expansion strategy through the enhancement of its portfolio of sequencing products, and development of strategic partnerships with therapeutics and diagnostic services providers.”

Illumina’s revenue through the first three quarters of 2013 was more than 20 percent higher than the comparable period in 2012. Its third-quarter revenue was up more than 25 percent compared to the year-ago quarter.

Takeaway: Quest and LabCorp have moved forward in locking up deals with cutting-edge providers of sequencing and microarray equipment. 

Inside The Lab Industry



Ailing Domestically, Quest Diagnostics Makes Major Move in India

While Quest Diagnostics has been challenged in the United States in recent years to grow its business, there is one part of the globe where it will soon be expanding rapidly: India.

Earlier this month, Quest Diagnostics' India subsidiary announced a dramatic expansion of its oncology testing market. It plans to open 25 cancer service centers in various parts of the country, including major cities such as Mumbai, Bangalore, and Kolkata, the nation's first-, third-, and seventh-most populous cities, respectively.

Quest already has a significant collection and testing network in Delhi, the nation's second-largest city and its capital. Delhi was the site of a pilot program for cancer testing prior to the announced expansion.

"The incidence of cancer cases is on the rise in India. Today, patients and the treating physician need accurate and reliable diagnostic insights in order to make the right treatment decision," said Mukul Bagga, whom Quest recruited from pharmaceutical giant Novartis to head its Indian operations.

"The incidence of cancer cases is on the rise in India."

—Mukul Bagga,
Managing Director,
Quest Diagnostics India

In the last entry of a blog Bagga wrote about the pharmaceutical sector before he joined Quest last spring, he described the transition from pharmaceutical to laboratory services as a culture shock. "You have a menu of over 3,000 tests and you need to sell this as a service!" he mused, adding that market research reports for the lab sector in India are virtually non-existent.

Overseas Markets Provide Some Promise

Despite the dearth of hard numbers on market potential, the once skeptical view of India as a source of growth for the company appears to be turning.

John Macko, executive vice president in charge of strategy for MiraMed, a health care consulting company based in Jackson, Mich., noted that overseas markets may be the best option for publicly traded enterprises such as Quest these days.

"The Quests and Labcorps of the world, I don't believe they have a choice from a financial perspective," he said. "The market [in the United States] is fairly saturated, and they're getting less per test."

In 2013, Quest revenues declined 3.2 percent from 2012, to \$7.1 billion. For 2014, the company is projecting revenues to be flat to down 2 percent, continuing a trend that began in 2012.

Two years of declining revenue for a publicly traded company is usually more than enough for it to aggressively seek revenue growth, whether from

mergers and acquisitions—which Quest has also undertaken—or by entering new markets.

In addition to India, Macko cited Singapore, South America, and China as other potentially huge markets for U.S.-based lab companies.

Quest is no stranger to India; it began investing in the country about a decade ago. It built a 65,000-square-foot laboratory in Gurgaon, an affluent, centrally located city of about 900,000 located 25 miles south of Delhi. That lab was certified by the College of American Pathologists in 2008. In a nation where there are literally hundreds of thousands of laboratories—most of which are little more than mom-and-pop operations—only a handful have any sort of official certification.

Aside from India, Quest’s international presence is fairly limited, with some testing operations in Puerto Rico, Mexico, Brazil, and the United Kingdom. LabCorp has limited testing operations in Puerto Rico and Canada, but the vast majority of its business is in the United States.

“There is definitely an opportunity for Quest internationally.”

***—Amanda Murphy, Analyst,
William Blair & Co.***

The decision to move into India was made by the predecessor of current Quest Chief Executive Officer Steve Ruszkowski, Surya Mohapatra. An Indian native who was educated both there

and in the United Kingdom, Mohapatra came under heavy criticism for the business decision. It likely contributed to his exit under pressure from the company in 2012, after eight years as CEO and more than a dozen as a Quest executive.

Amanda Murphy, an analyst with William Blair & Co. in Chicago who covers Quest, confirmed that the Indian strategy did not initially bear fruit.

“It didn’t go well, and really didn’t take off,” she said. But she added that the environment may have changed. “There is definitely an opportunity for Quest internationally,” Murphy observed.

Cancer May Be Growth Engine

Apparently, Bagga and his executive team have latched onto cancer as the new engine for growth.

According to data cited by Quest India, there were just under 1 million cases diagnosed in the country in 2010. That number is projected to reach 1.1 million cases by 2020, Quest said. About 556,000 Indians died from the disease in 2010.

Those numbers are almost certainly underreported. In the United States, about 1.7 million cancer cases were diagnosed in 2013, according to the American Cancer Society. There were about 580,000 cancer-related deaths last year.

The U.S. population is 314 million—a fraction of the 1.2 billion people who live in India.

Economy Is Growing Rapidly

Although hundreds of millions of Indians live in poverty and the per capita income averages only about \$100 a month, the economy is growing rapidly, often 6 percent or more annually in recent years. Per capita income is expected to reach an average of \$350 a month by the end of the decade and, perhaps more significantly, represent nearly \$13,000 a year in equivalent purchasing power in the United States, according to the International Monetary Fund. The nation also has a rapidly growing segment of urban upper and middle classes who have the income to improve and monitor their health and will likely take aggressive medical measures should they become ill.

And while India does not have a government-run health system, it has a rapidly growing health care services sector that includes hundreds of privately run clinics and hospitals, many of which are on par in terms of the quality of care provided by facilities in Europe and the United States.

“We continue to regard India as an important market and look forward to extending our cancer services to patients in the country.”

***—Wendy Bost,
Spokesperson for Quest***

According to Macko, that the United States has been using India’s white-collar labor force to outsource a variety of tasks such as Web site design and legal services has created an expectation among those workers that they can patronize

American businesses. “Those people now need health care services and lab tests, and telemedicine is really changing the way that works,” he said.

Indeed, Quest’s oncology diagnostics strategy appears to be leveraging both that demographic growth and long-distance communications. Although its tests are priced accordingly for Indian pocketbooks, it also provides a digital platform to share test results with clinicians in the United States to provide their opinions about potential treatment options. Sending test results abroad for interpretation can mean a premium of up to 30 percent above the original test price, Bagga recently told the *Hindustan Times*, an English-language newspaper in India.

In addition to basic testing for breast, cervical, prostate, soft tissue, and bone cancers, Quest’s India operations are also offering esoteric testing for certain types of hematological cancers, as well as an assay for detecting mutations in the ROS1 gene, which can help determine certain care pathways for patients with lung cancer.

However, Quest did not want to provide any financial specifics regarding its overseas market, citing its upcoming release of earnings for the fourth quarter of 2013, according to company spokesperson Wendy Bost.

“We continue to regard India as an important market and look forward to extending our cancer services to patients in the country,” Bost said.

Takeaway: Faced with flat revenue and declining reimbursement in the United States, Quest Diagnostics may have to begin opening markets overseas far more aggressively than in the past. 

■ QUEST ACQUIRES SOLSTAS LAB PARTNERS, *from page 1*

"This acquisition represents an exciting opportunity for Quest and Solstas as well as our patients and customers in the region. Solstas has excellent client relationships and local presence in the Southeast, and we expect to build on the value of these assets with our broad and innovative test menu, scientific expertise and health IT solutions," said Quest Chief Executive Officer Steve Rusckowski in a statement.

Quest disclosed few other details about the transaction, which is expected to close before the end of the second quarter. Company spokesperson Wendy Bost observed that "we are just beginning our plans to make the most of this exciting opportunity" and declined to say if there would be any job cuts at Solstas, which has about 4,000 employees, or if the company would continue to operate under its own name.

The deal does appear to finally nudge Quest's revenues upward. Company officials say the transaction will add about 5 percent to its revenues on an annualized basis and will give a mild boost to earnings, perhaps as much as 10 cents per share, or about a 2.5 percent increase. Based on its recently issued guidance for 2013, that

"You have to wonder if [Solstas's ownership is] barely getting their money out of this."

***—Christopher Jahnle,
Managing Director,
Haverford Healthcare Advisors***

translates to about \$350 million in 2014.

Industry observers suggest the numbers indicate Solstas has been struggling in recent years.

Christopher Jahnle, managing director for Haverford Healthcare Advisors in Paoli, Pa., noted that Solstas has acquired a half-

dozen labs with about \$100 million in cumulative revenue since 2010 but that that same amount appears to have eroded from the company's top line.

The purchase price—which represents about 1.6 times annual revenue, also surprised Jahnle and other observers. The typical multiple is closer to twice annual revenue.

"Solstas' managed care contracts will likely look different under the Quest managed care umbrella; thus, we are not surprised by a lower revenue multiple," wrote Amanda Murphy and J.P. McKim of William Blair & Co. in a recent report.

"You have to wonder if [Solstas's ownership is] barely getting their money out of this," Jahnle said, noting that the discounted price is likely the reflection of both eroding revenue and difficulty integrating recent acquisitions. They include Oracle Diagnostic Laboratories, Hayes Clinical Laboratory, Southern Diagnostic Laboratories, Nextwave Diagnostic Laboratories, Wilmington Pathology Laboratory, and Select Diagnostics.

And acquisition or not, Quest still appears shaky for 2014.

"Despite the recent acquisition announcement of Solstas Lab Partners, we remain cautious on Quest heading into the [final 2013 earnings report] as we believe shares could trade lower," wrote Bradley Maiers and Kevin K. Ellich of Piper Jaffray in a recent report. The two analysts believe Quest's upcoming guidance for 2014 could actually be lower than the current consensus of \$4.20 a share.

Takeaway: Quest's challenge to grow its revenue stream has prompted it to make one of the biggest acquisitions in the lab sector in recent years. 

Johnson & Johnson Selling Off Diagnostics Business

The Carlyle Group apparently sees a big future in the laboratory business.

The Washington, D.C.-based asset management giant has made a \$4.2 billion bid for Johnson & Johnson's ortho-clinical diagnostics division.

That division, which is based in Raritan, N.J., does not focus on laboratory testing specifically, instead distributing a testing platform known as Vitros, along with the associated reagents to perform a menu of about 120 different assays. However, it has developed a variety of assays over the decades, including standardized blood-typing tests. Its most recent new tests assist in the detection of prostate cancer.

Johnson & Johnson's diagnostics division has been hit hard in the past year. Domestic revenue was down 9.7 percent in 2013, and 8.1 percent overseas, compared to brisk growth for the rest of the company, which has posted 30 consecutive years of earnings increases. Diagnostics generated \$1.9 billion in revenue last year, accounting for about 2.5 percent of overall revenues. Johnson & Johnson began exploring strategic options for the division in January of last year.

Although Johnson & Johnson has yet to formally accept the offer, it appears it is moving in that direction.

"Ortho-Clinical Diagnostics plays an important role in health care, and we're confident that it's well positioned to serve the interests of its patients, customers, and employees," said Alex Gorsky, Johnson & Johnson's chief executive officer. "This transaction is a result of our disciplined approach to portfolio management in order to achieve the greatest value for Johnson & Johnson."

During the company's recent call to discuss earnings, Gorsky said that Johnson & Johnson was "very committed to working with the Carlyle Group to make sure that this transition goes as seamlessly as possible."

The company has until March 31 to accept the offer, which is partly conditional on the acceptance of the division's unionized workforce. If accepted, the deal is expected to close by the middle of 2014, pending antitrust review by regulators.

Takeaway: An underperforming laboratory division makes an attractive asset to another party.



References

Aurora Diagnostics 866-420-5512	Haverford Healthcare Advisors 610-407-4024	Quest Diagnostics 800-222-0446
Carlyle Group 202-729-5626	Illumina 858-202-4500	Solstas Lab Partners 336-664-6100
Clinical Lab Business Solutions 908-237-2808	Johnson & Johnson 800-828-6316	William Blair & Co. 312-236-1600
	LabCorp 800-845-6167	

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: LIRN11)

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.