Is the value of hospital lab outreach underrated?

Ron Shinkman

December 2016—Hospitals across the nation have been selling their laboratory outreach operations to national laboratories, which have been snapping them up from community hospitals and larger enterprises. Take Henry Mayo New-hall Hospital in California (LabCorp) and Hartford HealthCare in Connecticut (Quest Diagnostics) this year, for example, and MemorialCare in California (Quest) in 2015.

Management executives at many hospitals and health systems have said their impetus to sell is to focus on what they consider more profitable parts of their operations. And observers say such transactions are likely to continue.

But what if it turns out that selling those laboratory businesses means their owners are actually selling them short?

Murphy

That's what Kathleen Murphy believes. The longtime CEO of Chi Solutions stepped down from that position earlier this year after the Michigan-based consulting firm was acquired by Accumen. Although Murphy remains with Chi as a senior advisor, she suggested at the start of a blunt, data-filled presentation at G2 Intelligence's Lab Institute in Washington, DC, in late October that her lower profile allowed her to speak more freely.

"I like to be a little contrarian and challenge positive beliefs," she said. "I may be a tad politically incorrect."

First, Murphy contended that the hospital laboratory outreach business is doing quite well. According to data Chi accumulated through its industry surveys, in 2013 the average outreach program enjoyed $58.33 of revenue per requisition (compared with slightly more than $44 apiece for both Quest and LabCorp); annual revenue growth per requisition of 5.3 percent (versus a 4.3 percent decline and a one percent dip for Quest and LabCorp, respectively); and a profit margin of 28 percent per requisition (compared with less than 19 percent for Quest and less than 16 percent for LabCorp).

And outreach has grown significantly over the years. Murphy said when she began studying outreach programs in the early 1990s, each one averaged about $5 million in annual revenue. Now it's about $19 million. Many hospital laboratory outreach programs are significantly larger than that, with some topping $100 million a year in revenue and others reporting more than $50 million in revenue.

Moreover, successful hospital laboratory outreach can furnish more than half of a hospital's pre-tax earnings while accounting for less than 10 percent of its overall cost.

"It's one of the best-kept secrets in health care," Murphy said.

It's a secret to some hospital executives as well. Murphy noted that just more than a quarter of hospital laboratories actually have the appropriate data to run their businesses, a situation she called "management by braille."

Murphy is not the only person to hold this opinion.

"I agree to the letter with this," says Larry Small, chief executive officer of LabPath Consulting in Tierra Verde, Fla.

Small says many hospitals simply book their gross revenues without looking at outreach-related net revenues. That's exacerbated when it comes to billing, as laboratory is often mixed with other services such as x-rays.

"When billing through the hospital's billing accounts receivable system, hospitals generally can't track the net revenue per test. As a result, they often don't really know how much outreach business they have or have a process in place to measure the profitability or value of their outreach business," Small says.

Patrick Allen, a managing director at Kaufman, Hall & Associates in Skokie, Ill., says the outreach business is sometimes not viewed as a standalone business offering and held to the same efficiency test as other business units. "And by not breaking them up and understanding what their real profitability is as part of the institution as a whole, they can be undervalued," he says.

Small

According to Small, many hospitals approach the laboratory outreach marketplace with a "grazing," as opposed to a "farming," mentality, and thus without a strategic business plan for growing a separate and distinct profitable business that adds value to the hospital or health system.

"If they would farm it, they would grow that business tremendously, and they can very handily defeat the competition of the large independent labs because patients in the community want to use their service," Small says.

That's borne out by more of Murphy's data, which indicated that in 2016, 92 percent of hospital outreach operations were holding their own or gaining against Quest's market share, while 86 percent were doing the same against LabCorp. According to Chi, it's the best performance numbers for hospital outreach since 2011. Allen agrees—"in terms of volume and market share," he says.

Not only does this suggest hospitals may be misjudging the need to sell their outreach, but they lack the data necessary to negotiate a strong sales price. "At the end of the day, then they end up getting taken for a ride," Small says.

An exception was the Hartford HealthCare deal. The parent health care system had spun off its laboratory operations as a separate entity (Clinical Laboratory Partners), he says, giving Hartford specific numbers for its negotiations with Quest.

There is not full agreement that laboratories are unsung cash cows for hospitals. Dennis Weissman, a laboratory consultant in Washington, DC, believes the fiscal environment is a little more uneven than Murphy suggests it is.

"Some hospital labs do a good job, but others have a tough time, and there's lots of competition," he says. The new PAMA rules will wind up flattening payments to hospital labs over the next few years, Weissman adds, making those that are high performers less lucrative.

Allen

“I agree [PAMA’s] going to cause some issues,” says Allen. “Hospitals typically are unable to break out lab costs for their inpatient business, and that’s becoming a problem. They’re going to have to be competitive with other service providers, and if they can’t unbundle part of a [DRG] code or bundled payment [for lab], they will have to take what’s left over, and they are going to struggle.” He adds that commercial payers are also pressuring hospitals to keep their laboratory costs in line with those of standalone entities.

Moreover, the rising employment of physicians by hospitals is also causing headwinds, Allen says. “A lot of hospitals are trying to work with those physicians to lower costs and provide appropriate care,” he says. “And the physicians are saying that the hospital and outreach labs tend to be higher priced than the LabCorp, Quests, and Sonics of the world. To be honest, while [buying physician practices] is driving some of the physician lab work back into the hospital, as everyone is evaluating the total cost of care, it becomes a pressure point that requires reevaluation.”

Murphy and Small do believe there are ways for hospitals to recognize the value of their laboratory outreach and move to protect and grow it.

One of the first things to do, Small says, is to spin the outreach business into a separate corporation, or even just obtain a separate National Provider Identifier number. Once that is accomplished, the laboratory should enter into a purchasing agreement with the hospital. Separate books keep both the hospital and the lab wholly informed as to earnings, revenue, and other financial metrics.

“The lab directors see the value of their operations, and the pathologists see the value, but the problem is they can’t convince the administration of the value,” Small says.

Murphy concluded her presentation by observing there is “no rational way to say outreach isn’t good,” but that many hospital executives act out of fear as opposed to rationality.

As a result, she exhorted those running laboratories to be more direct with hospital management. Murphy suggested trying to convince them as if they were persuading a venture capitalist to invest in the operation.

“Here’s a question to ask your CEO if he gives you crap: ‘What other plan do you have to make more money with less risk?’” Murphy said. “When I ask CEOs this question, they look at me with that deer in the headlights look. Sometimes you need to just challenge them.”

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