

# Industry Flash Report – Laboratory Services

November 2016

The annual revenue of the U.S. diagnostic and medical laboratory industry is estimated to be \$75 billion. From 2011 to 2016, the industry grew at a compound annual growth rate of 0.8%. It is expected that the industry will grow at an annualized rate of 1.3% through 2021. Volume rose due to an aging U.S. population, pressure to reduce treatment costs, and an increased focus on preventive medicine, each of which results in a higher volume of lab procedures. However, profit in the industry has declined due to increasingly compressed reimbursement rates. Synergies resulting from industry consolidations have offset some of these pressures. The participants in partnership processes have diversified, driving more innovative structures and pressuring the largest labs to enhance their proposals.

## Implications to Clients

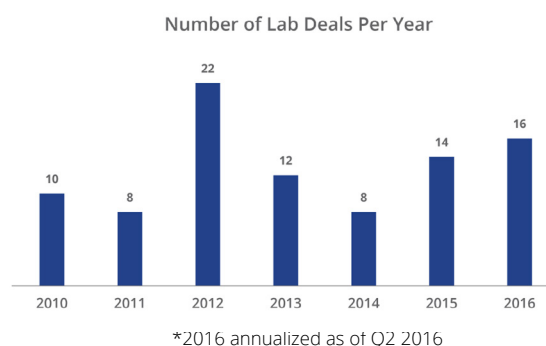
Hospital labs are assessing strategic options at an accelerated pace. These systems look to unique partners and structures to satisfy their goals and objectives. In a rapidly changing industry, time is of the essence to determine the optimal path.

## Overview of Laboratory Services Industry

- Lab testing accounts for only ~2% of healthcare expenditures but influences more than 70% of physician decisions
- Hospital-based labs are increasingly experiencing downward pressures due to several key trends including the following:
  - **Rate Compression:** The growth of high deductible plans and heightened consumer awareness/sensitivity have driven declines in volume, prompting labs to accept lower rates. Expected impacts from the Protecting Access to Medicare Act (PAMA) will drive rate compression as well
  - **Hospital Lab Consolidation:** Consolidation in the labs space drives a lower overall cost per test, allowing large labs to accept price reductions and strengthen their positions versus hospital labs
  - **Payer Consolidation:** Payers are gaining enhanced bargaining power to negotiate fee arrangements with labs, including limitations on the lab network (sometimes to a single lab provider). Only the largest labs will be able to compete on price to win these prized contracts

## Transaction Activity

Merger and acquisition activity has grown as acquirers continue to look to diversify and enhance scale.



M&A Activity of Major Publicly Traded Lab Companies:

- The two largest publicly traded independent labs have continued to make acquisitions: Quest has announced 1 transaction and Lab Corp. has announced 2 transactions so far in 2016
- M&A activity has largely been motivated by the pressures experienced by hospital-based labs, coupled with Quest's and LabCorp's desire to increase market share and diversify product lines, utilizing scale as a value proposition
- Future growth through partnerships with hospital systems is desirable for the larger labs, as they look to entrench themselves in local communities through existing platforms and to broaden their esoteric testing businesses

Key Heath System Transactions in 2015/2016 included:

Healthcare System	Lab Partner	Structure	Value Proposition to Partners
HealthOne (HCA)	Quest	Management of six Denver-area hospitals (2016)	- Improve the quality and value of diagnostic services across the network - Reduce costs
Hartford Healthcare	Quest	Acquisition of outreach laboratory business of Clinical Partners (CLP), a wholly-owned subsidiary of Hartford Healthcare (2015)	- Provide greater access and convenience to patients - Collaborate on population health and data analytics - Offset exposure to reimbursement risk - Reduce costs
RWJBarnabas	Quest	Management of seven New Jersey area hospitals (2015)	- Provide patients and consumers access to expanded information connectivity options - Reduce costs - Access to Quest's IntelliTest Analytics solution, which provides timely access to utilization insights

## Major Players and Market Multiples

Laboratory Corporation of America Holdings [NYSE: LH]

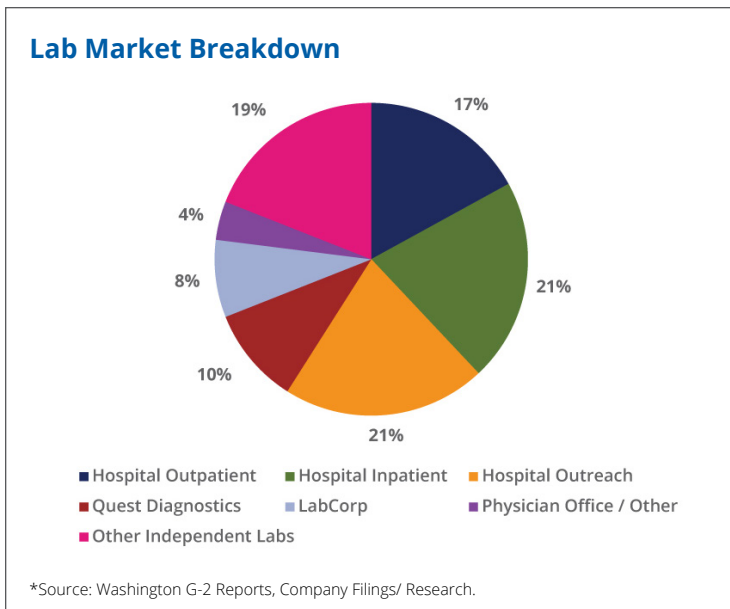
- Performs 183 million patient tests annually
- Operates 39 primary laboratories and more than 1,750 service centers
- Locations throughout the U.S., Canada, U.K., and the United Arab Emirates

Quest Diagnostics, Inc. [NYSE: DGX]

- Serves approximately half of the physicians and hospitals in the U.S. and touches the lives of ~30% of American adults each year
- Operates dozens of clinical labs throughout the U.S. and more than 2,300 patient service centers
- Locations in the U.S., India, Ireland, Mexico, and the U.K.

Sonic Healthcare Ltd. [ASX:SHL]

- Offers a range of more than 3,000 different tests
- Operates ~220 laboratories worldwide, with ~18 locations across the U.S., and serves as the parent company of 32 operating companies across the world
- Locations in Australia, New Zealand, the U.K., Germany, Switzerland, and the U.S.



	Trailing 12 Months		TEV/ Operating Revenue	TEV/ EBITDA	EBITDA Margin
	Total Revenue	EBITDA			
Laboratory Corp. of American Holdings	\$9,029	\$1,739	2.3x	12.0x	19.3%
Quest Diagnostics Inc.	\$7,517	\$1,481	2.1x	10.9x	19.7%
Sonic Healthcare Limited	\$3,724	\$622	2.5x	15.0x	16.7%

Note: Results include Covance, Inc. which closed in the first quarter of 2015.

Sources: 2016 IBIS World Report, U.S. Clinical Laboratory and Pathology Testing 2013-2015, Capital IQ, Irving Levin, and Public Reports.

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