

Brief Scare for Investors in Clinical Laboratories



James W. Anness/The Record, via Associated Press

Thousands of laboratory test samples in racks at Quest Diagnostics in Teterboro, N.J. Quest is the largest of the independent lab companies.

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Was it merely a passing cloud? Investors were briefly nervous a week ago Monday when Quest Diagnostics, the largest medical-testing company, disclosed that it had received subpoenas from the Justice Department about its contracts with the federal government and other leading customers from 1993 to 1999.

Many investors may have recalled that the mid-90's were years when the clinical laboratory industry seemed on the verge of crumbling under the weight of price wars and wide-ranging inquiries into overcharging and other fraudulent business practices. Deep-pocket players like [Corning](#), Hoffman-La Roche and SmithKline Beecham fled the business by spinning off or selling their tarnished subsidiaries.

Investors were uneasy enough about Quest's disclosure to send its recently highflying shares down \$1.01, to \$105.42, in trading a week ago Monday. But a second subpoena disclosure - the next day from the Laboratory Corporation of America - soon quieted fears that the latest Justice Department investigation might bring new exposure of misconduct at the labs and additional liabilities.

LabCorp, as it is known, disclosed in its filing with the Securities and Exchange Commission that it had been asked for the same types of information as Quest. LabCorp added that it had been told by the Justice Department that it was not a target of the investigation. Quest then indicated for the first time that it had been given similar guidance by federal investigators.

The Justice Department, as usual, declined to comment. That left open the question of why the United States attorney's office in Newark was looking at the contracts. But it was enough for Wall Street to settle back into its current view of the labs as a business segment with a \$35 billion to \$38 billion annual market in the United States, dependable profits and growth prospects that are modest but clear.

Combined revenue for the four publicly traded companies in the sector is forecast by Thomson Financial to climb about 6 percent this year and earnings to rise at a pace about double that, with somewhat higher rates for the two smaller public companies: LabOne and [Specialty Laboratories](#).

Three of the field's stocks have been trading close to 52-week highs reached in recent weeks. But Specialty Labs has been hobbled this spring by tension between senior managers and its founder and controlling shareholder, James B. Peter. It is now searching for both a new chief executive and a new chief financial officer.

"The sector is trading at a premium because it's a safe haven," said Thomas Gallucci, who follows the testing companies for [Merrill Lynch](#). "There's not a lot of businesses that have this kind of visibility and steady growth." (Merrill has banking relationships with Quest and Specialty.)

To hear the companies and analysts tell it, the 1990's are history. The lab companies say they have introduced stringent quality controls to prevent recurrences of the abuses. Nor, they say, are they as dependent as they once were on wringing every last cent out of routine analysis of fluid and tissue specimens.

Breakthroughs like the mapping of the human genome have spawned a flood of new types of analytical jobs for them, like tests that identify which patients are susceptible to particular types of heart disease or cancer.

"The role of diagnostics is very different from 10 years ago," said Dr. Surya N. Mohapatra, the chairman and chief executive of Quest. "Now they are used not only to diagnose disease but to monitor therapy and predict disease."

The visibility is partly a result of the current structure of the testing business, according to Robert Michel, a consultant in Spicewood, Tex., who publishes *The Dark Report*, a newsletter focused on clinical testing. Some 50 percent to 60 percent of the business is conducted by pathology departments in hospitals and clinics, about

25 percent in doctors' offices and the rest in the independent labs operated by companies like Quest, according to Mr. Michel, who does not invest in any of the companies.

After more than a decade of acquiring rivals, Quest, based in Lyndhurst, N.J., is the clear leader in the independent sector. Net income last year was \$507 million on \$5.13 billion in revenue. LabCorp, which has also been a serial acquirer and is based in Burlington, N.C., had income of \$363 million on revenue of \$3.08 billion. Quest's earnings per share have risen 36.7 percent annually over the last five years while LabCorp's have grown 26.7 percent.

Both companies are far larger than their competitors and operate nationwide networks of laboratories that perform routine tests like Pap smears and urinalysis as well as labs that do more demanding tasks like searches for particular proteins associated with cancer or complex gene analysis.

As analysts see it, an aging population means a steady growth in the number of tests, while the current structure of the business with just two broad-based companies and specialized expertise required for the more unusual tests makes price wars unlikely. "The market likes companies that aren't going to miss numbers," said William Bonello of [Wachovia](#) Securities.

If the industry agrees on anything, it is the opportunity presented by diagnostic tests being developed to assess illness, or even the risk of future illness, by analyzing a patient's DNA and RNA, the storehouses of genetic information. New and nonroutine tests are the only part of the business consistently growing at double-digit rates.

Most new tests are developed outside the lab companies, which license them or sometimes buy the developer. But this advanced-technology business is also attracting new competitors, like Genomic Health, a start-up in Redwood City, Calif., that has developed a gene test to help oncologists predict which breast cancer patients are most likely to suffer a recurrence and which chemotherapy treatments will work best for their cancer. Genomic Health, still privately held, has set up its own laboratory to process specimens sent to it by doctors.

Ultimately, the big lab companies not only need to have access to the new technology but also to figure out how to deliver it profitably on a large scale.

"The danger is that the large labs have such a broad range of tests to sell that they may not be focusing on the new ones," said Matthew C. Watson, who recently became chief executive of Combimatrix Molecular Diagnostics, a newly formed unit of the Combimatrix Corporation, which is owned by [Acacia Research](#), a holding company in Newport Beach, Calif.

The new business aims to develop diagnostic kits from devices Combimatrix makes to automate tests on large arrays of DNA snippets. Such arrays are used by researchers for tasks like identifying compounds that might be useful drugs.

And what about that passing cloud? Wall Street may have breathed a sigh of relief and turned its attention elsewhere after Quest and LabCorp said that they were not targets of the federal investigation. But Mr. Michel, the newsletter writer, said the inquiry, like those in the 1990's, could still affect the lab companies by leading to new rules on how they can do business.

"It won't result in an economic blow," Mr. Michel said, "but it could end up as a wedge affecting today's business practices."