Client Brief:
Laboratory Acquisition

Key words: acquisition, valuation, modeling, forecasting

Conundrum: A small community hospital lab was competing with an even smaller local physician-owned lab. How could they reduce competition and both increase net income?

Synopsis: The community hospital ran a virtually full-service lab to support timely inpatient and outpatient needs, as well as critical 24/7 emergency department needs. Incremental volume would have been extremely profitable given the high fixed costs of simply maintaining the lab. However, the physician lab was able to "cherry-pick" key tests and generate contribution margin to the group practice, even though their fixed costs were also fairly high. The group practice was also able to direct lab work based on profitability.

Suzanne hypothesized that the economics of consolidating the labs' operations could potentially yield enough incremental profit to entice both labs to the negotiating table. To explore this, she examined the actual economics of the two labs, analyzing the revenues and costs associated with the tests performed at each lab, including the impacts of payer mix, volume, and fixed and variable costs. She developed a flexible valuation model with key variable drivers that both the hospital and the physician group could understand, and in the process they were able to agree upon model assumptions.

Having identified the potential financial benefits of the acquisition of the physician lab by the hospital, Suzanne developed a terms sheet/ memo of understanding between the parties, defining the structure and characteristics of the transaction. The valuation was validated by a nationally recognized accounting firm, and the structure was endorsed by a law firm, enabling the acquisition to take place within a "safe harbor" of transactions between hospitals and admitting physicians.

Ultimately, an agreement more profitable to both parties was reached.

Benefit/outcome: It resulted in the purchase of the physician laboratory by the hospital, which increased hospital volume 40% and revenue over $1 million per year with minor incremental variable expense increase. The purchase payments over time to the physician group more than replaced the lost income stream.

Client type: community hospital

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