Pace of Hospital Lab Acquisitions Likely to Remain Steady, Industry Observers Say

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NEW YORK — Amidst a global pandemic and an ever-shifting reimbursement environment, Laboratory Corporation of America and Quest Diagnostics have continued a steady pace of hospital lab acquisitions.

According to figures from Scottsdale, Arizona-based lab consulting firm Accumen, between 2017 and 2019 the two lab giants combined completed 18 hospital laboratory deals, with Quest notching 12 and Labcorp six. Between 2020 and 2022, the pair closed another 18 deals, this time with Labcorp leading the way with 10 and Quest following with eight.

And while some observers suggested that, with many of the more straightforward transactions now done, the pace of hospital lab acquisitions will slacken, Jeff Myers, VP of consulting services at Accumen, said that this recent history indicates the flow of deals is likely to continue.

"I would argue that it continues to be a stable area," he said. "The facts show that acquisitions have not really slowed down."

For their part, Quest and Labcorp maintain that they have robust acquisition pipelines and that, in fact, the pace of deals could accelerate in the aftermath of the COVID-19 pandemic.

"It's an opportunistic time for us," Quest's then President, Chairman, and CEO Steve Rusckowski (he has since been succeeded as president and CEO by Jim Davis) said during the company's Q3 earnings call in October. He said that factors including rising wages are leading hospital systems to explore selling or otherwise outsourcing portions of their lab businesses.

"We are seeing that hospital systems are more open to discussions than before the pandemic," he said. "Many large and small health systems face substantial financial and labor pressures that make our range of services very attractive."

Speaking during Labcorp's Q3 earnings call, Chairman and CEO Adam Schechter likewise said the company's "hospital and local lab acquisition and investment pipeline is very robust" and that it sees "major opportunity now through 2023."

Keith Laughman, founder and managing partner with Caretinuum Consulting, likewise suggested that hospital lab acquisitions are likely to continue at the pace of recent years unless health systems move to take their local markets back.

"Commercial labs have picked up a lot of low-hanging fruit, but they will need to continue to buy market share to meet their growth goals," he said.

Laughman framed this as a defensive strategy on the part of the national labs, arguing that, as health systems continue to employ independent doctors, national labs could find it difficult to penetrate those markets if those physician practices direct the bulk of their testing to the health system's laboratories.

"If they don't buy these local competitors — and that's really what [hospital labs] are — then they will be on the outside looking in," he said.

Myers agreed that the national labs' acquisition strategies are in part a defensive response to consolidation of health systems and physician practices. More than half of doctors are employees of health systems, according to him, causing a drop in revenue for national labs. As a result, the labs remain "very, very" engaged in potential acquisitions, as evidenced by transactions done during the past six years.

The same health system consolidation that is spurring national labs' acquisitions has also made these systems more formidable negotiators, said David Nichols, president and founder of lab services consulting firm Nichols Management Group, adding that in recent years labs have been acquired at valuations "as high or higher than ever."

"Hospital executives are continuing to become more sophisticated because they are responsible for larger and larger systems," he said. "In the old days, you would buy a hospital's outreach lab, and now you are buying a health system's outreach lab. So, it's more sophisticated management that you are dealing with."

The relationship between a system's size and its willingness to sell is a complicated one, though, Nichols said.

"Frequently what systems will do, is they will roll up physician labs and other hospitals in an area, and then once they get to a certain scale, then they can sell the lab," he said. "Maybe their lab was doing $20 million a year. Well, after they buy all these physician practices and other hospitals, maybe that lab is now doing $100 million a year, and all of a sudden it is something worth monetizing [through a sale]."

On the other hand, that scale and local dominance can give the hospital lab significant leverage in negotiations around reimbursement. Lab margins can differ dramatically, Nichols said, and if a health system has a large scale in a local community, they can get twice the reimbursement rate of what another health system can typically get.

That said, payors have been exerting downward pressure on outreach lab reimbursement, which he noted has driven some systems to sell despite their current strong pricing power.

"A lot of people think, well, I'm going to lose my advantage anyway because the Blues or Cigna or United keep squeezing me on my lab reimbursement, so I might as well sell now while I have a fungible asset because it is going to be worth less and less money to me as time goes by, and the [national labs] are really hungry," he said.

Laughman added that some health systems may be charging too much for the testing they do in the ambulatory non-patient market and said that while the infrastructure costs involved in hospital inpatient and registered outpatient testing make higher pricing necessary, hospital systems should be able to compete with national labs on price and service for the non-registered patient ambulatory testing.

Jason Bush, executive VP of product at lab benefit management firm Avalon Healthcare Solutions, said that he has seen "small concessions" in pricing at some outreach labs but that "overall there is still a large differential between hospital outreach laboratories and independent laboratories."

He said, though, that longer term, he sees factors including increased price transparency and price sensitivity on the part of consumers as well as payor pressure bringing outreach pricing more into line with pricing at independent labs.

"You're going to see a stabilization of rates so that the outreach laboratories will be competitive in the market with the independents and the regionals for laboratory services," he said, though he added that the time frame for that development "is uncertain."

Outreach labs and the lab industry more generally could see some relief from downward pricing pressures if the Saving Access to Laboratory Services Act, or SALSA, passes Congress this year. Meant to reform the Protecting Access to Medicare Act (PAMA), the bill would institute a sampling-based approach to collecting lab test pricing data and place caps limiting the maximum price cut or rise a test could see under PAMA to 5 percent a year.

It would also stop price cuts scheduled under current law to go into effect at the start of 2023, extending the time between price reporting periods from three years to four.

While passage of SALSA would alleviate some of the reimbursement challenges facing outreach labs, Nichols said that the potential sellers his firm is involved with have by and large already priced in its passage — or that at the very least Congress will once again postpone the scheduled PAMA rate cuts and kick the can down the road.

"They know that some form of SALSA is going to come through," he said. "We could be wrong, but I don't know of anyone who thinks we are going to get a 15 percent cut [as called for under PAMA] in January. Stranger things have happened, but if I had to bet, I would say there is a 5 percent chance that we will get that haircut."

Nichols said that more concerning for healthcare systems is the pressure coming from private payors who have in recent years sought to equalize rates across lab types or incentivize members to have testing done at large national labs.

Despite these pressures, Laughman suggested that the move toward more value-based care could incentivize hospital systems to retain control of their laboratories and expand their labs' presences in the community to serve non-hospital patient care settings.

"The lab generates 70 percent of the data in the medical record," he said. "It influences almost all decisions — it either triggers the clinical decision or verifies it. And when you start shipping specimens out of the community for cheap tests, you ignore the value that the local hospital lab generates in the episode of care."

Accumen's Myers suggested, though, that many large health systems aren't able to rigorously

determine even the revenue generated by their lab assets, let alone assess the value they bring to the broader mission of patient care.

"The biggest gap in understanding the value of outreach is that hospitals report their financial statements, their revenues and costs, in a consolidated way," he said. "We, as a hospital executive group, could have a $30 million outreach program, and we don't even know, because it is all co-mingled" with other parts of the business.

"The biggest reason to me that health systems are unable to get line of sight to the economic value of outreach is that there is not delineated, separate financial reporting for outreach," he said.

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