SPECIALTY LABORATORIES
Form 10-Q
November 09, 2001

QuickLinks -- Click here to rapidly navigate through this document

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

/x/ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2001

OR

/ / **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ______ to ______

Commission file number 001-16217

SPECIALTY LABORATORIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

California	**95-2961036**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

2211 Michigan Avenue
Santa Monica, California 90404
(Address of principal executive offices, including zip code)

Registrant's Telephone Number, Including Area Code: **(310) 828-6543**

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes /x/ No / /

As of November 8, 2001, there were approximately 21,463,973 shares of Common Stock outstanding, no par value.

SPECIALTY LABORATORIES, INC.

FORM 10-Q QUARTERLY REPORT

TABLE OF CONTENTS

		Page
PART I. FINANCIAL INFORMATION		
ITEM 1.	FINANCIAL STATEMENTS	1
ITEM 2.	MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	7
ITEM 3.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	24
PART II. OTHER INFORMATION		
ITEM 1.	LEGAL PROCEEDINGS	25
ITEM 2.	CHANGES IN SECURITIES AND USE OF PROCEEDS	25
ITEM 3.	DEFAULTS UPON SENIOR SECURITIES	25
ITEM 4.	SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS	25
ITEM 5.	OTHER INFORMATION	25
ITEM 6.	EXHIBITS AND REPORTS ON FORM 8-K	25

This Quarterly Report on Form 10-Q, (the "Quarterly Report") including information incorporated herein by reference, contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements relate to expectations concerning matters that are not historical facts. Words such as "projects," "believes," "anticipates," "will," "estimate," "plans," "expects," "intends," and similar words and expressions are intended to identify forward-looking statements. Although we believe that such forward-looking statements are reasonable, we cannot assure you that such expectations will prove to be correct. Important language regarding factors which could cause actual results to differ materially from such expectations are disclosed in this Quarterly Report and in filings with the Securities and Exchange Commission ("SEC") made from time to time by Specialty Laboratories, including our Registration Statement on Form S-1 declared effective on December 7, 2000, our Annual Report on Form 10-K filed on March 30, 2001 and other periodic filings on Form 10-Q and Form 8-K. All forward-looking statements attributable to Specialty Laboratories are expressly qualified in their entirety by such language. We do not undertake any obligation to update any forward-looking statements.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Specialty Laboratories, Inc.
Consolidated Balance Sheet

	December 31, 2000	September 30, 2001
		(Unaudited)
Assets		
Current assets:		
Cash and cash equivalents	$ 75,603,555	$ 19,507,660
Short-term investments		29,814,746
Accounts receivable, less allowance for doubtful accounts of $4,030,665 as of December 31, 2000 and $3,924,416 as of September 30, 2001	32,775,147	35,786,610
Deferred income taxes	4,238,857	3,263,289

	December 31, 2000	September 30, 2001
Inventory	1,623,115	2,361,529
Prepaid expenses and other assets	1,496,125	2,069,978
Total current assets	115,736,799	92,803,812
Property and equipment, net	19,891,132	18,831,937
Long-term investments		29,563,247
Deferred income taxes	2,863,427	1,398,392
Goodwill, net		5,297,838
Other assets	3,513,707	4,854,319
	$ 142,005,065	$ 152,749,545
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	$ 11,921,443	$ 13,462,633
Accrued liabilities	10,387,764	7,936,342
Income taxes payable	4,638,422	1,294,417
Total current liabilities	26,947,629	22,693,392
Long-term liabilities	3,259,950	2,501,006
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized, none issued		
Common stock, no par value; 100,000,000 shares authorized, 20,937,507 shares issued and outstanding as of December 31, 2000 and 21,373,108 shares issued and outstanding as of September 30, 2001	89,824,176	94,641,765
Retained earnings	24,102,877	33,662,981
Deferred stock-based compensation	(2,129,567)	(941,812)
Unrealized gain on investments		192,213
Total shareholders' equity	111,797,486	127,555,147
	$ 142,005,065	$ 152,749,545

1

Specialty Laboratories, Inc.
Consolidated Statements of Operations
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2000	**2001**	**2000**	**2001**
Net revenue	$ 39,549,842	$ 42,842,245	$ 113,713,886	$ 131,821,432
Costs and expenses:				
Costs of services	21,895,033	25,049,322	64,110,497	75,101,688
	12,372,752	13,558,951	36,257,832	42,488,197

	Three Months Ended September 30,		Nine Months Ended September 30,	
Selling, general and administrative (exclusive of stock-based compensation charges)				
Stock-based compensation charges	562,090	228,318	706,454	907,447
Write-down of unused facilities	369,495		369,494	
Total costs and expenses	35,199,370	38,836,591	101,444,277	118,497,332
Operating income	4,350,472	4,005,654	12,269,609	13,324,100
Interest income	(1,709)	(838,025)	(14,625)	(2,866,593)
Interest expense	270,144	31,050	1,030,202	109,239
Income before income taxes	4,082,037	4,812,629	11,254,032	16,081,454
Provision for income taxes	1,704,003	1,901,000	4,644,000	6,521,350
Net income	$ 2,378,034	$ 2,911,629	$ 6,610,032	$ 9,560,104
Basic earnings per common share	$ .15	$ .14	$ .42	$ .45
Diluted earnings per common share	$ .14	$ .13	$ .38	$ .43

2

Specialty Laboratories, Inc.
Consolidated Statements of Cash Flows
(Unaudited)

	Nine Months Ended September 30,	
	2000	**2001**
Operating activities		
Income from operations	$ 6,610,032	$ 9,560,104
Adjustments to reconcile income from operations to net cash provided by operating activities:		
Depreciation and amortization	4,387,886	5,220,940
Tax benefits related to employee stock options		3,607,325
Deferred income taxes	(225,000)	2,440,603
Stock-based compensation charges	706,454	907,447
Loss on disposals of property and equipment	23,041	7,697
Write-down of unused facilities	369,494	
Changes in assets and liabilities, net of effects of acquisition:		
Accounts receivable, net	(5,893,406)	(974,464)
Inventory, prepaid expenses and other assets	698,365	(212,613)
Accounts payable	122,083	893,303
Accrued liabilities	(873,097)	(2,451,834)
Income taxes payable	2,603,911	(3,344,005)
Other long-term liabilities	680,309	(758,944)
Net cash provided by operating activities	9,210,072	14,895,559

	Nine Months Ended September 30,	
Investing activities		
Cash paid for acquisition of BBI Clinical Laboratories		(9,500,000)
Purchases of property and equipment	(4,644,183)	(3,796,246)
Purchase of short-term investments		(29,814,746)
Purchase of long-term investments, net of unrealized gains		(29,371,033)
Net cash used in investing activities	(4,644,183)	(72,482,025)
Financing activities		
Sale of common stock to employees	313,495	1,490,571
Net change in revolving bank line of credit	(9,940,874)	
Borrowings under bank term loans	6,186,491	
Repayment of bank term loans	(2,503,108)	
Repayment of loan by shareholder	850,000	
Net cash provided by (used in) financing activities	(5,093,996)	1,490,571
Net decrease in cash and cash equivalents	(528,107)	(56,095,895)
Cash and cash equivalents at beginning of period	717,298	75,603,555
Cash and cash equivalents at end of period	$ 189,191	$ 19,507,660
Supplemental disclosures of cash flow information:		
Acquisition of BBI Clinical Laboratories consisted of the following:		
Acquired assets		$ 10,148,298
Assumed liabilities		(648,298)
Total cash paid		$ 9,500,000

SPECIALTY LABORATORIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2001

(Unaudited)

NOTE 1. BASIS OF PRESENTATION

Financial Statement Preparation

The accompanying financial statements of Specialty Laboratories (the "Company") have been prepared, without audit, in accordance with generally accepted accounting principles for interim financial reporting and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the financial statements do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, such interim financial statements contain all adjustments (consisting of normal recurring items) considered necessary for a fair presentation of the Company's financial position, results for operations and cash flows for the interim periods presented. The results of operations and cash flows for any interim periods are not necessarily indicative of results that may be reported for the full year.

On December 13, 2000, we completed our initial public offering of our common stock, no par value. The shares of common stock sold in the offering were registered under the Securities Act of 1933, as amended, on a Registration Statement Form S-1 (the "Registration Statement") (Reg. No. 333-45588) that was declared effective by the Securities and Exchange Commission on December 7, 2000. The offering commenced on December 8, 2000 where all 5,000,000 shares of common stock registered under the Registration Statement were sold at a price of $16.00 per share. The Underwriters also exercised an overallotment option of 750,000 shares on December 11, 2000. All 750,000 shares were sold at a price of $16.00 per share. The aggregate price of the offering amount registered, including the overallotment was $92.0 million. In connection with the offering, we incurred underwriting discounts and commissions and other related offering expenses in the amount of approximately $8.7 million. We received net proceeds from the offering of approximately $83.3 million.

The accompanying financial statements should be read in conjunction with the audited consolidated financial statements, and the notes thereto, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000, as filed with the Securities and Exchange Commission.

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets" effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill will no longer be amortized but will be subject to annual impairment tests in accordance with the statements. Other intangible assets will continue to be amortized over their useful lives. The Company will apply the new rules on accounting for goodwill and other intangible assets beginning the first quarter of 2002. Application of the non-amortization provisions of the statement is not expected to have a material effect on the Company's financial statements. The Company will perform the first of the required impairment tests of goodwill as of January 1, 2002 and has not yet determined what the effect of these tests will be on the earnings and financial position of the Company.

NOTE 2. ACQUISITIONS

On February 20, 2001, the Company acquired certain assets and liabilities of BBI Clinical Laboratories, Inc., a Massachusetts corporation, for $9.5 million in cash. The purchase price was allocated to the assets acquired and liabilities assumed based on the estimated fair values as of the purchase closing date. Of the $9.5 million purchase price, approximately $5.45 million was allocated to

goodwill and $1.97 million was allocated to the customer list. The amortization life for goodwill and the customer list is 20 years and 10 years, respectively. The acquisition has been accounted for under the purchase method of accounting.

The following unaudited pro forma information presents the consolidated results of the Company's operations and the results of operations of the acquisition for the three and nine months ended September 30, 2001 as if the acquisition had been consummated on January 1, 2001. Consolidated operating results for the three and nine months ended September 30, 2000 are also presented on a pro forma basis as if the acquisition had been consummated on January 1, 2000. Such unaudited pro forma information is based on historical financial information with respect to the acquisition and does not include operational or other changes that might have been effected by the Company.

The unaudited pro forma information for the three and nine months ended September 30, 2000 and 2001 presented below is for illustrative information purposes only and is not indicative of results that may have been achieved or results that may be achieved in the future.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2000	2001	2000	2001
Net revenue	$ 41,550,842	$ 42,842,245	$ 120,326,886	$ 132,724,625
Net income	$ 2,288,034	$ 2,911,629	$ 6,403,632	$ 9,474,516
Basic earnings per common share	$ .15	$ .14	$ .40	$ .45
Diluted earnings per common share	$ .13	$ .13	$ .37	$ .43

NOTE 3. COMPOSITION OF CERTAIN BALANCE SHEET CAPTIONS

Property and Equipment

Property and equipment consists of the following:

	December 31, 2000	September 30, 2001
Information technology equipment and systems	$ 23,102,531	$ 25,041,112
Professional equipment	9,463,936	10,539,122
Office furniture and equipment	4,095,544	4,195,363
Leasehold improvements	7,962,575	8,549,268
Construction in progress	614,835	753,024
	45,239,421	49,077,889
Less accumulated depreciation and amortization	(25,348,289)	(30,245,952)
Total property and equipment, net	$ 19,891,132	$ 18,831,937

Goodwill

Goodwill related to the acquisition of BBI Clinical Laboratories is as follows:

	December 31, 2000	September 30, 2001
Goodwill	$	$ 5,457,000
Less accumulated amortization		(159,163)
Total goodwill, net	$	$ 5,297,838

5

Accrued and Long-Term Liabilities

Accrued liabilities consist of the following:

	December 31, 2000	September 30, 2001
Employee compensation related	$ 7,052,042	$ 6,873,547
Royalties	3,335,722	1,062,795
Total accrued liabilities	$ 10,387,764	$ 7,936,342

The Company has various royalty agreements for technology licensed from third parties which require that royalty fees be paid based upon a percentage of net revenue derived from assays using the licensed technology. Royalty payments are generally made on a semiannual basis.

Long-term liabilities consist of the following:

	December 31, 2000	September 30, 2001
Deferred compensation	$ 1,908,057	$ 1,782,513
Annuity payments due to former employee	453,164	375,133
Non-current portion of accrued rent for unused facility	232,359	43,360
Non-current installment of software acquisition costs	600,000	300,000
Other	66,370	
Total long-term liabilities	$ 3,259,950	$ 2,501,006

NOTE 4. EARNINGS PER SHARE

Basic earnings per share is computed by dividing income attributable to common stockholders by the weighted-average number of common shares outstanding for the respective periods. Diluted earnings per share, calculated using the treasury stock method, gives effect to the potential dilution that could occur upon the exercise of certain stock options that were outstanding during the respective periods presented.

Basic and diluted earnings per share for the respective periods are set forth in the table below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2000	**2001**	**2000**	**2001**
Net income	$ 2,378,034	$ 2,911,629	$ 6,610,032	$ 9,560,104
Basic earnings per common share	$ .15	$ .14	$ .42	$ .45
Diluted earnings per common share	$ .14	$ .13	$ .38	$ .43
Basic weighted average shares outstanding	15,582,298	21,334,165	15,904,042	21,103,125
Effects of dilutive stock options	1,613,536	979,797	1,522,430	1,101,148
Diluted weighted average shares outstanding	17,195,834	22,313,962	17,426,472	22,204,273

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with our selected consolidated financial data and the consolidated financial statements and related notes included elsewhere in this Quarterly Report. This section includes forward-looking information that involves risks and uncertainties. Our actual results could differ materially from those anticipated by forward-looking statements.

For purposes of the following discussion, EBITDA consists of income from operations before interest, income taxes, depreciation and amortization. EBITDA should not be considered a measure of financial performance under GAAP. Items excluded from EBITDA are significant components in understanding and assessing overall financial performance. We present EBITDA, which is a non-GAAP measure, to enhance the understanding of our operating results. EBITDA should not be considered in isolation or as an alternative to net income, cash flows generated by operations, investing or financing activities, or other financial statement data presented in the consolidated financial statements as indicators of financial performance or liquidity.

Overview

Specialty Laboratories is a leading research-based clinical laboratory predominantly focused on developing and performing esoteric clinical laboratory tests, which we refer to as assays. We believe we offer one of the industry's most comprehensive menus, comprised of more than 3,500 esoteric assays, many of which have been developed through our internal research and development efforts. Esoteric assays are complex, comprehensive or unique tests used to diagnose, evaluate and monitor patients. These assays are often performed on sophisticated instruments by highly skilled personnel and are therefore offered by a limited number of clinical laboratories.

Our primary customers are hospitals, independent clinical laboratories and physicians. We have aligned our interests with those of hospitals, our fastest growing client segment, by not competing in the routine test market that provides them with a valuable source of revenue. We educate physicians on the clinical value of our assays through our information-oriented marketing campaigns. Our technical, experienced sales force concentrates on the hospitals and independent laboratories that serve as distribution channels for physician assay orders. We use our advanced information technology solutions to accelerate and automate electronic assay ordering and results reporting with these customers.

We believe that our typical esoteric assay is priced at approximately twice that of a routine test. Our assays also have higher costs than routine tests due to the necessity of specialized laboratory instruments and highly skilled laboratory personnel. If we are successful in obtaining or renewing large customer or group purchasing organization contracts, our average price per assay may slightly decrease, as these contracts typically incorporate volume discounts.

Results of Operations

The following table sets forth the percentage of net revenue represented by certain items in our consolidated statements of operations for the three months and nine months ended September 30, 2000

and 2001. Also presented is our working capital as calculated from our consolidated balance sheet for the nine months ended September 30, 2000 and 2001.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2000	**2001**	**2000**	**2001**
Net revenue	100.0%	100.0%	100.0%	100.0%
Cost of services	55.4	58.5	56.4	57.0
Selling, general and administrative (exclusive of stock-based compensation charges)	31.3	31.6	31.9	32.2
Operating income	11.0	9.3	10.8	10.1
Income from operations before taxes	10.3	11.2	9.9	12.2
Net income	6.0	6.8	5.8	7.3

	Nine Months Ended September 30,	
	2000	**2001**
Working capital	$ 10,034,715	$ 70,110,420

Quarter Ended September 30, 2001 Compared with Quarter Ended September 30, 2000

Net Revenue

Net revenue increased approximately $3.3 million, or 8.3%, to $42.8 million for the quarter ended September 30, 2001 from $39.5 million for the quarter ended September 30, 2000. Revenue grew as a direct result of increased accession volumes offset partially by a decline in the aggregate average selling price. This accession growth came primarily from our existing business, increasing by nearly 16% in the third quarter of 2001 as compared to the year ago quarter. The accession volumes for third quarter of 2001 remained essentially flat compared to second quarter of 2001 due in part to a lower number of business days in the third quarter coupled with the temporary impact to our business as a result of the events of September 11, 2001. On a per business day basis, accession volumes grew by more than 19%. The aggregate average selling price in the third quarter of 2001 was down over 6% as compared to the third quarter of 2000. This reduction is reflective of test mix changes resulting from our growing hospital customer base, pricing reductions in contract renewals and the significant impact on our test mix volume in September due to the September 11 tragedy.

Cost of Services

Cost of services, which includes costs for laboratory operations, distribution services, and research and development, increased approximately $3.1 million, or 14.4%, to $25.0 million for the third quarter 2001 from $21.9 million for the comparable prior year quarter and reflects a decline of approximately $470,000 as compared to second quarter 2001. This year over year increase is directly attributed to the increase in assay volume and the costs associated with the addition of the clinical operations of BBI Clinical Laboratories acquired in the first quarter of 2001. As a percentage of net revenue, cost of services increased to 58.5% for the quarter ended September 30, 2001 from 55.4% from the comparable prior year quarter. This increase is primarily the result of the reduction in aggregate average selling price, a temporary increase of approximately $200,000 in transportation and laboratory operating costs associated with maintaining patient testing and turn around times following the events of September 11, and the costs of maintaining redundant operations as we completed the transition of clinical operations of BBI Clinical Laboratories to our Santa Monica facilities in the third quarter.

Selling, General and Administrative Expenses

Selling, general and administrative expenses (S,G&A) increased approximately $1.2 million, or 9.6%, to $13.6 million for the third quarter 2001 from $12.4 million for the third quarter 2000. Selling, marketing and related expenses accounted for over $500,000 of the growth in S,G&A resulting from increased revenues and servicing a larger customer base. The administration of BBI Clinical Laboratories added over $300,000 to S,G&A, which includes approximately $117,000 recorded for amortization of intangible assets in the third quarter of 2001. The continued rollout of our customer related offerings of DataPassport and DataPassportMD and the beta testing of our Outreach Express product contributed approximately $200,000 of incremental S,G&A. As a percentage of net revenue, selling, general and administrative expenses increased slightly to 31.6% for the third quarter of 2001 as compared to 31.3% for the quarter a year ago.

Stock-Based Compensation Charges

Stock-based compensation charges decreased from approximately $562,000 recorded in the third quarter of 2000 to approximately $228,000 recorded in the third quarter 2001. This decrease was related to the amortization of deferred stock compensation.

Write-down of Unused Facilities

A property lease between the Company and a partnership in which the Company's Chairman of the Board and Chief Executive Officer was both a direct and indirect owner was terminated on September 1, 2000 on which date the Company had a balance of approximately $369,000 in unamortized leasehold improvements for this property. A loss for this amount was recognized in third quarter 2000. No additional losses were recorded during third quarter 2001.

Interest Income

Interest income increased to approximately $838,000 for the third quarter 2001 from approximately $2,000 for the comparable prior year quarter. This income is the result of investments being made with the proceeds from our initial public offering held in December 2000 as funds have been invested in money market, short-term and long-term investments.

Interest Expense

Interest expense decreased to approximately $31,000 for the third quarter 2001 from approximately $270,000 for the same quarter a year ago. This decrease is due to the reduction of debt in December 2000 with a portion of the funds received from our initial public offering.

Provision for Income Taxes

Provision for income taxes was $1.9 million for the third quarter 2001 as compared to $1.7 million for the comparable prior year quarter. Our effective tax rate was 39.5% for the third quarter 2001 as compared to 41.7% for the third quarter 2000. The Company currently estimates its annual effective tax rate to be approximately 40% for fiscal 2001 compared to approximately 41% for fiscal 2000. The current year effective tax rate has decreased as a result of tax planning reviews and initiatives.

Net Income

Net income increased by approximately $534,000, or 22.4%, to $2.9 million for third quarter 2001 from $2.4 million for the comparable prior year quarter. The increase is due primarily to a growth in our assay volume, operating efficiencies, interest income recognized on the investment of funds from our initial public offering and lower interest expense due to reduced debt. As a percentage of net

revenue, net income increased to 6.8% for the quarter ended September 30, 2001 as compared to 6.0% for the comparable quarter of 2000.

EBITDA and Adjusted EBITDA

EBITDA decreased by less than $100,000, or 1.4%, to $5.8 million for the third quarter 2001 from $5.9 million for the comparable prior year quarter. As a percentage of net revenue, EBITDA decreased to 13.5% for the quarter ended September 30, 2001 from 14.9% for third quarter 2000. Adjusting EBITDA for the non-cash expense related to stock-based compensation charges, adjusted EBITDA decreased by approximately $788,000, or 11.6%, to $6.0 million for the third quarter 2001 from $6.8 million for the comparable prior year quarter. As a percentage of net revenue, adjusted EBITDA decreased to 14.1% for the quarter ended September 30, 2001 from 17.2% for the third quarter 2000. These results reflect the temporary increase in transportation and laboratory operating costs incurred in September, redundant operating costs associated with the transition of the clinical operations of BBI Clinical Laboratories to our Santa Monica facilities, offset somewhat by the improved efficiencies achieved through the ongoing automation of our laboratory operations and the economies of scale realized by processing higher assay volumes.

Nine Months Ended September 30, 2001 Compared with Nine Months Ended September 30, 2000

Net Revenue

Net revenue increased approximately $18.1 million, or 15.9%, to $131.8 million for the nine months ended September 30, 2001 from $113.7 million for the nine months ended September 30, 2000 as revenues from our hospital clients grew to approximately 57% of total revenues in the first nine months of 2001 as compared to approximately 50% in the same period of 2000. Revenue grew as a direct result of increased accession volumes, which increased by nearly 20%, offset partially by a decline in average selling prices. This accession growth came primarily from our existing business, increasing approximately 18% in the first nine months of 2001 as compared to the year ago period. The accession volumes resulting from the acquisition of BBI Clinical Laboratories on February 20, 2001 accounted for nearly two percentage points of growth. Average selling prices for the first nine months of 2001 declined approximately 3% as compared to the first nine months of 2000. This reduction in average selling prices is reflective of test mix changes resulting from our growing hospital customer base, pricing reductions in contract renewals and the test mix volume in September due to the events of September 11.

Cost of Services

Cost of services, which includes costs for laboratory operations, distribution services, and research and development, increased approximately $11.0 million, or 17.1%, to $75.1 million for the first nine months of 2001 from $64.1 million for the comparable prior year period. This increase is directly attributed to the increase in assay volume and the costs associated with the acquisition of the clinical operations of BBI Clinical Laboratories in first quarter 2001. During this period, we maintained redundant operations as we transitioned the clinical operations of BBI Clinical Laboratories to our Santa Monica facilities. The transition of laboratory operations was completed during the third quarter. As a percentage of revenue, cost of services increased to 57.0% for the nine months ended September 30, 2001 from 56.4% from the comparable prior year period. This decline is reflective of the additional costs associated with the BBI Clinical Laboratories acquisition offset partially by the improved efficiencies provided by the ongoing automation of our laboratory operations and the economies of scale realized by processing significantly higher assay volume.

Selling, General and Administrative Expenses

Selling, general and administrative expenses (S,G&A) increased approximately $6.2 million, or 17.2%, to $42.5 million for the first nine months of 2001 from $36.3 million for the first nine months of 2000. Selling, marketing and related expenses accounted for approximately $1.9 million of this growth in S,G&A resulting from increased revenues and servicing a larger customer base. The acquisition of BBI Clinical Laboratories added more than $1.4 million to S,G&A, which includes approximately $400,000 of certain one-time charges associated with the acquisition and approximately $274,000 recorded for amortization of intangible assets during the first nine months of 2001. Approximately $1.2 million of the increase was due to us increasing our corporate infrastructure to support our business growth and to meet the requirements of being a public company. Expansion of our customer related offerings of DataPassportMD and the beta testing of our Outreach Express contributed over $600,000 of incremental S,G&A. As a percentage of revenue, selling, general and administrative expenses increased to 32.2% for the first nine months of 2001 as compared to 31.9% for the same period last year.

Stock-Based Compensation Charges

Stock-based compensation charges increased from approximately $706,000 recorded in the first nine months of 2000 to approximately $907,000 recorded in the first nine months of 2001. This increase was related to the amortization of deferred stock compensation.

Write-down of Unused Facilities

A property lease between the Company and a partnership in which the Company's Chairman of the Board and Chief Executive Officer was both a direct and indirect owner was terminated on September 1, 2000 on which date the Company had a balance of approximately $369,000 in unamortized leasehold improvements for this property. A loss for this amount was recognized in September 1, 2000. No additional losses were recorded during first nine months of 2001.

Interest Income

Interest income increased to approximately $2.9 million for the first nine months of 2001 from approximately $15,000 for the first nine months of 2000. This increase in income is the result of investments being made with the proceeds from our initial public offering held in

December 2000 as funds have been invested in money market, short-term and long-term investments.

Interest Expense

Interest expense decreased to approximately $109,000 for the first nine months of 2001 from approximately $1.0 million for the first nine months of 2000. This decrease is due to the reduction of debt in December 2000 with a portion of the funds received from our initial public offering.

Provision for Income Taxes

Provision for income taxes was $6.5 million for the first nine months of 2001 as compared to $4.6 million for the comparable prior year period. Our effective tax rate declined slightly to 40.6% for the first nine months of 2001 from 41.3% for the first nine months of 2000. The Company currently estimates its annual effective tax rate to be approximately 40% for fiscal 2001 compared to approximately 41% for fiscal 2000. The effective tax rate decline is a result of tax planning reviews and initiatives.

Net Income

Net income increased by approximately $3.0 million, or 44.6%, to approximately $9.6 million for first nine months of 2001 from approximately $6.6 million for the comparable prior year period. The increase is due primarily to an increase in operating income resulting from higher assay volume, efficiencies provided by ongoing automation of assays, and interest income recognized on the investment of funds from our initial public offering. As a percentage of net revenue, net income increased to 7.3% for the nine months ended September 30, 2001 as compared to 5.8% for the comparable prior year period.

EBITDA and Adjusted EBITDA

EBITDA increased by approximately $1.9 million, or 11.3%, to $18.5 million for the first nine months of 2001 from $16.6 million for the comparable prior year period. As a percentage of net revenue, EBITDA decreased to 14.1% for the nine months ended September 30, 2001 from 14.6% for the comparable prior year period. These results reflect our maintaining redundant operations as we transitioned the clinical operations of BBI Clinical Laboratories to our Santa Monica facilities. Adjusting EBITDA for the non-cash e