SPECIALTY LABORATORIES
Form 10-Q
May 15, 2001

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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 March 31, 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 May 14, 2001, there were approximately 20,937,507 shares of Common Stock outstanding, no par value.

SPECIALTY LABORATORIES, INC.

FORM 10-Q QUARTERLY REPORT

TABLE OF CONTENTS

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 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	March 31, 2001
		(Unaudited)

	December 31, 2000	March 31, 2001
Assets		
Current assets:		
Cash and cash equivalents	$ 75,603,555	$ 31,859,312
Short-term investments		31,870,596
Accounts receivable, less allowance for doubtful accounts of $4,030,665 as of December 31, 2000 and $4,818,648 as of March 31, 2001	32,775,147	38,108,988
Deferred income taxes	4,238,857	3,950,521
Inventory	1,623,115	2,557,462
Prepaid expenses and other assets	1,496,125	1,918,778
Total current assets	115,736,799	110,265,657
Property and equipment, net	19,891,132	19,955,887
Long-term investments		5,086,260
Deferred income taxes	2,863,427	2,863,427
Goodwill, net		5,434,262
Other assets	3,513,707	4,482,116
	$ 142,005,065	$ 148,087,608
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	$ 11,921,443	$ 15,194,277
Accrued liabilities	10,387,764	9,532,092
Income taxes payable	4,638,422	4,714,436
Total current liabilities	26,947,629	29,440,805
Long-term liabilities	3,259,950	3,127,547
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 March 31, 2001	89,824,176	89,543,868
Retained earnings	24,102,877	27,505,239
Deferred stock-based compensation	(2,129,567)	(1,534,184)
Unrealized gain on investments		4,333
Total shareholders' equity	111,797,486	115,519,256
	$ 142,005,065	$ 148,087,608

Specialty Laboratories, Inc.

Consolidated Statements of Operations

(Unaudited)

Three Months Ended March 31,

	2000	2001
Net revenue	$ 35,607,095	$ 43,821,622
Costs and expenses:		
Costs of services	20,515,676	24,534,040
Selling, general and administrative (exclusive of stock-based compensation charges)	11,604,644	14,313,909
Stock-based compensation charges	33,266	315,075
Total costs and expenses	32,153,586	39,163,024
Operating income	3,453,510	4,658,598
Interest income	(12,916)	(1,145,844)
Interest expense	371,022	37,730
Income before income taxes	3,095,404	5,766,712
Provision for income taxes	1,269,000	2,364,350
Net income	$ 1,826,404	$ 3,402,362
Basic earnings per common share	$ .11	$ .16
Diluted earnings per common share	$ .10	$ .15

Specialty Laboratories, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

	Three Months Ended March 31,	
	2000	2001
Operating activities		
Income from operations	$ 1,826,404	$ 3,402,362
Adjustments to reconcile income from operations to net cash provided by operating activities:		
Depreciation and amortization	1,388,066	1,672,820
Deferred income taxes	(62,000)	288,336
Stock-based compensation charges	33,266	315,075
Loss on disposals of property and equipment	8,375	1,382
Changes in assets and liabilities, net of effects of acquisition:		
Accounts receivable, net	(895,589)	(3,296,843)
Inventory, prepaid expenses and other assets	818,333	212,457
Accounts payable	(2,016,807)	2,624,949
Accrued liabilities	709,252	(856,082)
Income taxes payable	1,341,558	76,014
Other long-term liabilities	(43,620)	(132,403)

	Three Months Ended March 31,	
Net cash provided by operating activities	3,107,237	4,308,067
Investing activities		
Cash paid for acquisition of BBI Clinical Laboratories		(9,500,000)
Purchases of property and equipment	(783,870)	(1,599,785)
Purchase of short-term investments		(31,870,596)
Purchase of long-term investments, net of unrealized gains		(5,081,928)
Net cash used in investing activities	(783,870)	(48,052,309)
Financing activities		
Net change in revolving bank line of credit	(8,954,276)	
Borrowings under bank term loans	6,057,607	
Repayment of bank term loans	(619,561)	
Repayment of loan by shareholder	850,000	
Net cash used in financing activities	(2,666,230)	
Net decrease in cash and cash equivalents	(342,863)	(43,744,242)
Cash and cash equivalents at beginning of period	717,297	75,603,555
Cash and cash equivalents at end of period	$ 374,434	$ 31,859,312
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

March 31, 2001

(Unaudited)

NOTE 1. BASIS OF PRESENTATION

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 $92,000,000. In connection with the offering, we incurred underwriting discounts and commissions and other related offering expenses in the amount of approximately $8,667,000. We received net proceeds from the offering of approximately $83,333,000.

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.

NOTE 2. ACQUISITIONS

On February 20, 2001, the Company acquired certain assets and liabilities of BBI Clinical Laboratories, Inc., a Massachusetts corporation, for $9,500,000 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 $9,500,000 purchase price, $5,457,000 was allocated to Goodwill and $1,972,000 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 months ended March 31, 2001 as if the acquisition had been consummated on January 1, 2001. Consolidated operating results for the three months ended March 31, 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 months ended March 31, 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 March 31,	
	2000	2001
Net revenue	$ 37,947,095	$ 44,724,815
Net income	$ 1,751,474	$ 3,316,774
Basic earnings per common share	$ .11	$ .16
Diluted earnings per common share	$ .10	$ .15

NOTE 3. COMPOSITION OF CERTAIN BALANCE SHEET CAPTIONS

Property and Equipment

Property and equipment consists of the following:

	December 31, 2000	March 31, 2001
Information technology equipment and systems	$ 23,102,531	$ 23,952,470
Professional equipment	9,463,936	10,053,875
Office furniture and equipment	4,095,544	4,174,618
Leasehold improvements	7,962,575	8,183,038
Construction in progress	614,835	567,537
	45,239,421	46,931,538
Less accumulated depreciation and amortization	(25,348,289)	(26,975,651)
Total property and equipment, net	$ 19,891,132	$ 19,955,887

Goodwill

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

	December 31, 2000	March 31, 2001
Goodwill	$	$ 5,457,000
Less accumulated amortization		(22,738)
Total goodwill, net	$	$ 5,434,262

Accrued and Long-Term Liabilities

Accrued liabilities consist of the following:

	December 31, 2000	March 31, 2001
Employee compensation related	$ 7,052,042	$ 5,041,878
Royalties	3,335,722	4,490,214
Total accrued liabilities	$ 10,387,764	$ 9,532,092

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	March 31, 2001
Deferred compensation	$ 1,908,057	$ 1,891,266
Annuity payments due to former employee	453,164	427,401
Non-current portion of accrued rent for unused facility	232,359	170,455
Non-current installment of software acquisition costs	600,000	600,000
Other	66,370	38,425
Total long-term liabilities	$ 3,259,950	$ 3,127,547

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 March 31,	
	2000	2001
Net income	$ 1,826,404	$ 3,402,362
Basic earnings per common share	$ .11	$ .16

	Three Months ended March 31,	
Diluted earnings per common share	$ .10	$ .15
Basic weighted average shares outstanding	16,066,681	20,937,507
Effects of dilutive stock options	1,482,538	1,184,983
Diluted weighted average shares outstanding	17,549,219	22,122,490

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.

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 $92,000,000. In connection with the offering, we incurred underwriting discounts and commissions and other related offering expenses in the amount of approximately $8,667,000. We received net proceeds from the offering of approximately $83,333,000.

On February 20, 2001, we completed the acquisition of substantially all of the assets of BBI Clinical Laboratories, Inc., a wholly-owned subsidiary of Boston Biomedica, Inc., a public company. We paid $9,500,000 in cash which was accounted for as a purchase in the first quarter of 2001. BBI Clinical Laboratories, a private company founded in 1989, is a leading esoteric clinical reference laboratory specializing in infectious disease testing, such as Lyme Disease and viral hepatitis. BBI Clinical Laboratories' primary customers include hospitals, physician specialists, pharmaceutical and diagnostic companies and other clinical and research laboratories.

John C. Kane, recently retired President and Chief Operating Officer of Cardinal Health, was appointed to the Company's Board of Directors on March 1, 2001. Mr. Kane's career in healthcare includes 19 years at Abbott Laboratories where he served as President of the Ross Laboratories division. He joined Cardinal Health, a publicly traded Fortune 60 company and leading provider of products and services supporting the health care industry, as President and Chief Operating Officer in 1993.

We signed a three-year renewal agreement with Novation as a preferred provider of clinical laboratory services. Novation is the largest supply cost management company in health care representing 2,200 health care organizations. The agreement takes effect on May 1, 2001 and runs through April 30, 2004, with the option of two, one-year extensions at Novation's discretion.

Recent Developments

On April 9, 2001, Specialty Laboratories announced the appointment of Nancy-Ann DeParle, former Administrator of Health Care Financing Administration (HCFA), Department of Health and Human Services, to its Board of Directors. As HCFA Administrator from November 1997 to October 2000, Ms. DeParle directed the Medicare, Medicaid and State Children's Health Insurance Programs. As a key White House policy advisor, she led successful efforts to modernize the Medicare program, improve program and reimbursement integrity and extend the life of the Medicare Trust Fund. With Ms. DeParle's appointment, the Board of Specialty Laboratories has been expanded to nine Directors.

Results of Operations

The following table sets forth the percentage of net revenue represented by certain items in our consolidated statements of operations and our working capital as calculated from our consolidated balance sheet for the three months ended March 31, 2000 and 2001.

	Three Months Ended March 31,	
	2000	2001
Net revenue	100.0%	100.0%
Cost of services	57.6	56.0
Selling, general and administrative (exclusive of stock-based compensation charges)	32.6	32.7
Operating income	9.7	10.6
Income from operations before taxes	8.7	13.2
Net income	5.1	7.8

	As of March 31,	
	2000	2001
Working capital	$ 3,362,645	$ 80,824,852

Quarter Ended March 31, 2001 Compared with Quarter Ended March 31, 2000

Net Revenue

Net revenue increased $8.2 million, or 23.1%, to $43.8 million for the quarter ended March 31, 2001 from $35.6 million for the quarter ended March 31, 2000. Revenue grew as a result of increased accession volumes in our existing business, increasing more than 21% in the first quarter of 2001 as compared to the year ago quarter. With the additional volumes resulting from the acquisition of BBI Clinical Laboratories on February 20, 2001, total accessions grew by nearly 23%. Accordingly, average accession price in the first quarter of 2001 was up slightly as compared to the first quarter of 2000. Hospitals accounted for approximately 56% of our net revenue for the first quarter 2001 as compared to

49% for the comparable prior year quarter.

Cost of Services

Cost of services, which includes costs for laboratory operations, distribution services, and research and development, increased $4.0 million, or 19.6%, to $24.5 million for the first quarter 2001 from $20.5 million for the comparable prior year quarter. This increase is directly attributed to the increase in assay volume during the same period. As a percentage of revenue, cost of services decreased to 56.0% for the quarter ended March 31, 2001 from 57.6% from the comparable prior year quarter. The decrease reflects the 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 increased $2.7 million, or 23.3%, to $14.3 million for the first quarter 2001 from $11.6 million for the first quarter 2000. Approximately $1.0 million of this increase was due to us increasing our corporate infrastructure to support our growth and to meet the requirements of being a public company. Selling and related expenses increased nearly $400,000 due to the increase in sales volume and customer base. Expansion of our customer related offerings of DataPassportMD and the beta testing of our Outreach Express contributed $370,000 to additional Information Technology costs. We also incurred certain one-time charges, of approximately $400,000, associated with the acquisition of BBI Clinical Laboratories. As a percentage of revenue, selling, general and administrative expenses remained relatively flat at 32.7% for the first quarter of 2001 as compared to 32.6% for the quarter a year ago.

Stock-Based Compensation Charges

Stock-based compensation charges increased from approximately $33,000 to $315,000 from the first quarter 2000 to the first quarter 2001. This increase was related to the amortization of deferred stock compensation.

Interest Income

Interest income of $1.1 million was recorded for the first quarter 2001. 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 $38,000 for the first quarter 2001 from $371,000 for the first quarter 2000. This decrease is due to the reduction of our bank borrowings and the payoff of our outstanding revolving and term loans in December 2000 with a portion of the funds received from our initial public offering.

Provision for Income Taxes

Provision for income taxes was $2.4 million for the first quarter 2001 as compared to $1.3 million for the comparable prior year quarter. Our effective tax rate remained at 41% for the first quarter 2001 representing no change from the prior year.

Net Income

Net income increased by $1.6 million, or 86.3%, to $3.4 million for first quarter 2001 from $1.8 million for the comparable prior year quarter. 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.

EBITDA and Adjusted EBITDA

EBITDA increased by $1.5 million, or 30.8%, to $6.3 million for the first quarter 2001 from $4.8 million for the comparable prior year quarter. As a percentage of net revenue, EBITDA increased to 14.4% for the quarter ended March 31, 2001 from 13.6% for the quarter a year ago. Adjusting EBITDA for the non-cash expense related to stock-based compensation charges, adjusted EBITDA increased by $1.7 million, or 36.3%, to $6.6 million for the first quarter 2001 from $4.9 million for the comparable prior year quarter. As a percentage of net revenue, adjusted EBITDA increased to 15.2% for the quarter ended March 31, 2001 from 13.7% for the quarter a year ago. These results reflect economies of scale associated with processing higher assay volume and efficiencies gained through ongoing automation of assays.

Liquidity and Capital Resources

The Company's working capital reached $80.8 million at March 31, 2001 an increase of $77.4 million from $3.4 million at March 31, 2000. This increase is primarily due to the funds received from our initial public offering in December 2000 that yielded approximately $83.3 million. A large portion of these funds is reflected in our working capital as part of cash and cash equivalents and short-term investments. In addition, $5.1 million of these proceeds have been invested in long-term investments.

Net cash provided by operating activities was $4.3 million in the first quarter 2001 as compared to $3.1 million for the prior year quarter. The $1.2 million improvement was primarily due to our improved operating performance as income from operations increased by $1.6 million.

Net cash used in investing activities reached $48.1 million for quarter ended March 31, 2001 up $47.3 million from $.8 million for the same period 2000. During the first quarter 2001, we repositioned a portion of our cash equivalents to short-term and long-term investments. This investment in high-grade commercial paper will provide a better net after tax yield on our funds. Major uses of cash were $9.5 million to acquire BBI Clinical Laboratories and $1.6 million spent for capital expenditures to expand our information technology platform and laboratory automation and equipment.

Net cash provided in financing activities was zero for first quarter 2001 as compared to $2.7 million in first quarter 2000. There was no activity to report since we did not borrow any funds from the bank and our outstanding revolving and term loans were paid off in fourth quarter 2000 with funds from our initial public offering.

We expect that existing cash and cash equivalents, short-term investments, and our current credit facility along with funds generated from operations will be sufficient to fund our operations, meet our capital requirements to support our growth, and allow strategic technology licensing and acquisitions for the next year.

Risk Factors

Any investment in shares of our common stock involves a high degree of risk. You should consider carefully the following information about these risks, together with all of the other information contained in this Quarterly Report and our Form 10-K before you decide to buy our common stock. If any of the following risks actually occur, our business, financial condition, results of operations and future growth prospects could be materially adversely affected. Additional risks and uncertainties not presently known to us or that we currently believe to be immaterial also may impair our business. Any adverse effect on our business, financial condition or results of operations could result in a decline in the trading price of our common stock and the loss of all or part of your investment.

If advances in technology allow others to perform assays similar to ours, the demand for our assays may decrease.

The esoteric clinical laboratory industry is characterized by advancing technology which may enable other clinical laboratories, hospitals, physicians or other medical providers to perform assays with properties similar to ours in a more efficient or cost-effective manner than is currently possible. Such technological advances may be introduced by, not just our competitors, but by any third party. For instance, a diagnostic manufacturing company may release an instrument or technology that would make it cost-effective for our customers to perform esoteric assays internally, rather than through us. If these or other advances in technology result in a decreased demand for our assays, our assay volume and net revenue would decline.

The esoteric clinical laboratory industry is intensely competitive. If we are unable to successfully compete, we may lose market share.

The esoteric clinical laboratory industry is highly competitive. This industry is dominated by several national independent laboratories, but includes many smaller niche and regional independent laboratories as well. Our primary competitors include:

large commercial enterprises, such as Quest Diagnostics, or Quest, and Laboratory Corporation of America, or LabCorp, that offer a wide test and product menu on a national scale;

smaller niche laboratories like Impath or Athena Diagnostics that focus on a narrow segment of the esoteric market; and

institutions such as Mayo Medical Laboratories, or Mayo, and Associated Regional University Pathologists, or Associated, that are affiliated with large medical centers or universities.

Large commercial enterprises, including Quest and LabCorp, have substantially greater financial resources and may have larger research and development programs and more sales and marketing channels than we do, enabling them to potentially develop and market competing assays. These enterprises may also be able to achieve greater economies of scale or establish contracts with payor groups on more favorable terms. Smaller niche laboratories compete with us based on their reputation for offering a narrow test menu. Academic and regional institutions generally lack the advantages of the larger commercial laboratories but still compete with us on a limited basis.

Any of our competitors may successfully develop and market assays that are either superior to, or are introduced prior to, our assays. If we do not compete effectively with other independent clinical laboratories, we may be unable to maintain or grow our market share.

The premium prices that we initially charge for new assays may drop if our competitors are able to develop and market competing assays more quickly than they currently do.

Typically, we market new esoteric assays at premium prices for several years before similar assays are developed as either standardized prepared kits for broad application or as internally developed assays by competing laboratories. The opportunity to sell our products at premium prices may be reduced or eliminated if our competitors are able to develop and market competing assays more quickly than they currently do.

For example, our net revenue from one assay for HIV Quantitation was:

in 1998, $19.7 million, or 17.3% of total 1998 net revenue;

in 1999, $17.3 million, or 13.3% of total 1999 net revenue; and

in 2000, $16.3 million, or 10.7% of total 2000 net revenue.

This decreasing trend has been primarily due to competition from subsequently introduced assays. If we are unable to develop newer assays which meet market demand, our net revenue and profit margins may decrease.

Some of our customers are also our primary competitors. If they reduce or discontinue purchasing our assays for competitive reasons, it will reduce our net revenue.

Some of our customers, such as Quest, LabCorp, Mayo and Associated, also compete with us by providing esoteric testing services. They often refer to us assays that they either cannot or elect not to perform themselves. For the year ended December 31, 2000, sales to our competitors were $10.4 million or 6.8% of our net revenue. These parties may decide not to refer assays to us because they wish to develop and market assays similar to ours. For example, in July 1997, SmithKline Beecham Clinical Laboratories, or SmithKline Labs, began to significantly limit the number of assays it referred to us. We believe that SmithKline Labs terminated its relationship with us because it decided to offer assays similar to ours. In 1996, SmithKline Labs comprised 21.7% of our net revenue, whereas in 2000, after being acquired by Quest, SmithKline Labs (excluding Quest accounts prior to the acquisition) only comprised 1.5% of our net revenue. If other independent laboratories decide to reduce or discontinue purchases of our assays for competitive reasons, it will reduce our net revenue.

If we are unable to develop and successfully market new assays or improve existing assays in a timely manner, our profit margins may decline.

In order to maintain our margins and benefit from the premium prices that we typically charge for our newly introduced esoteric assays, we must continually develop new assays and improve our existing assays through licensing arrangements with third parties and through the efforts of our R & D department. There is no assurance, however, that we will be able to maintain our current pace of developing and improving assays in the future. Even if we develop such assays in a timely manner, our customers may not utilize these new assays. If we fail to develop new technologies, release new or improved assays on a timely basis, or if such assays do not obtain market acceptance, our profit margins may decline.

If we fail to acquire licenses for new or improved assay technology platforms, we may not be able to accelerate assay improvement and development, which could harm our ability to increase our net revenue.

Our ability to accelerate new assay development and improve existing performance will depend, in part, on our ability to license new or improved assay technology platforms on favorable terms. We may not be able to negotiate acceptable licensing arrangements and we cannot be certain that such

arrangements will yield commercially successful assays. Further, even if we enter into such arrangements with these third parties, their devotion of resources to these efforts may not be within our control or influence. If we are unable to license these technologies at competitive rates, our research and development costs may increase. In addition, if we are unable to develop new or improved assays through such research and development efforts, our assays may be outdated when compared with our competition's assays, and our net revenue may decrease.

A significant portion of our net revenue depends on a single customer, Unilab Corporation. If our relationship with Unilab is terminated or not renewed, our business may suffer.

For the year ended December 31, 2000 and the year ended December 31, 1999, services to Unilab Corporation accounts comprised 9.6% and 7.4% of our net revenue, respectively. Although we have entered into an agreement with Unilab in which it has agreed to refer to us, until the agreement expires in October 2002, at least 90% of the esoteric laboratory services it outsources each year or, in the event of a change of control of Unilab or the purchase by Unilab of a licensed clinical laboratory with a test menu materially broader than that of Unilab, at least $800,000 of esoteric laboratory services per month, there is no assurance that it will uphold this obligation. In addition, if Unilab does not renew this agreement in October 2002, it will then no longer be under any obligation to provide us with minimum assay referrals. If, for any reason, Unilab's purchase of our services were to be materially reduced or if Unilab failed to renew its contract with us in October 2002, it may decrease our net revenue.

We rely on a few assays for a significant portion of our net revenue. If demand for these assays were to weaken for any reason, our net revenue would decrease.

A significant portion of our net revenue is derived from 20 assays. Net revenue from these 20 assays comprised approximately 54.5% of our total net revenue for the year ended December 31, 2000 and approximately 53.4% for the year ended December 31, 1999. In addition, for each of past three years, over 10% of our net revenue has been derived from one assay for HIV Quantitation. As a result, a significant portion of our net revenue is concentrated among these assays, and in particular, our HIV Quantitation assay. If competing assays are introduced by competitors or demand for these assays otherwise decreases, our net revenue would decrease.

If group purchasing organizations do not renew and maintain our contracts, we may lose an important mechanism by which to further penetrate the hospital customer base.

Many of our existing and potential hospital customers are part of group purchasing organizations, which typically pool independent hospitals together to negotiate for pricing and services, including prices for laboratory tests. These group purchasing organizations provide incentives to their participating hospitals to utilize clinical laboratories which have contracts with the group purchasing organizations.

Our participation in group purchasing organizations constitutes one aspect of our overall strategy to attract new hospital customers. We have contracts with five group purchasing organizations: AmeriNet, Joint Purchasing Organization, Managed Healthcare Associates, Novation (formerly known as VHA) and Shared Services Healthcare. We are typically granted non-exclusive provider status under these contracts. Our contract with our group purchasing organizations will expire at times from 2001 to 2004.

For the year ended December 31, 2000, sales of our services to hospitals which utilized the pricing structures under the Novation and AmeriNet group purchasing organization contracts comprised approximately $34.3 million or 22.4%, and approximately $7.6 million or 5.0% of our net revenues, respectively. Sales to hospitals within the other three group purchasing organizations comprised less

than 1% of our net revenues for the same period. These group purchasing organizations offer a substantial growth opportunity to gain additional revenue from existing hospital customers. While we believe that over 1,800 of our 2,200 hospital customers are affiliated with these five group purchasing organizations, only approximately 400 of these customers qualify for discounts under these contracts.

We cannot be certain that if our agreement with Novation, AmeriNet or any other group purchasing organization is terminated or not renewed, that we will be able to retain any of the accounts of the participating hospitals. If any hospital customer affiliated with a group purchasing organization no longer uses our services, it will reduce our net revenue. In addition, if we are unable to attract new hospital customers because any group purchasing organization contract is terminated, it may adversely affect our ability to grow our business.

Failure in our information technology systems could significantly increase turn-around time, reduce our production capacity, and otherwise disrupt our operations, which may reduce our customer base and result in lost net revenue.

Our success depends, in part, on the continued and uninterrupted performance of our information technology systems, including our DataPassport® suite of products. Sustained or repeated system failures that interrupt our ability to process assay orders, deliver assay results or perform assays in a timely manner would reduce significantly the attractiveness of our products to our customers. Our business, results of operations and financial condition could be materially and adversely affected by any damage or failure that interrupts or delays our operations.

Our computer systems are vulnerable to damage from a variety of sources, including telecommunications failures, malicious human acts and natural disasters. Moreover, despite network security measures, some of our servers are potentially vulnerable to physical or electronic break-ins, computer viruses and similar disruptive problems, in part because they are located at a third party web hosting company, Exodus Communications, in El Segundo, California, and we cannot control the maintenance and operation of the Exodus data centers. Despite the precautions we have taken, unanticipated problems affecting our systems could cause interruptions in our information technology systems.

We have insurance policies designed to cover losses arising from such interruptions. Our policies include coverage for commercial general liability with a limit of $10 million. However, these insurance policies may not adequately compensate us for any losses that may occur due to any failures in our systems.

If we lose our competitive position in providing valuable information technology solutions as an ancillary service to our customers, we may not be able to maintain or grow our market share.

Over the past four years, we have made a substantial investment in our information technology solutions, such as DataPassport® and DataPassportMD , to facilitate electronic assay ordering and results reporting as a value added service for our customers. Based on management's experience in the industry and discussions with our customers, we believe that our competitors have not yet implemented similar information technology tools. We further believe that these solutions are one factor considered by our customers when selecting a reference laboratory. In the future, our competitors may offer similar or better information technology solutions to our existing and potential customer base. If this occurs, we will lose this competitive advantage, and as a result, may be unable to maintain or increase our market share.

Clinicians or patients using our products or services may sue us and our insurance may not sufficiently cover all claims brought against us, which will increase our expenses.

The development, marketing, sale and performance of healthcare services exposes us to the risk of litigation, including medical malpractice. Damages assessed in connection with, and the costs of defending, any legal action could be substantial. We currently maintain insurance with coverage up to $20 million, either singly or in the aggregate, which we believe to be adequate to cover our exposure in our current professional liability claims and employee-related matters which were incurred in the ordinary course of business. Although we believe that these claims may not have a material effect on us, because we expect them to be covered by this insurance, we may be faced with litigation claims which exceed our insurance coverage or are not covered under our insurance policy. In addition, litigation could have a material adverse effect on our business if it impacts our existing and potential customer relationships, creates adverse public relations, diverts management resources from the operation of the business or hampers our ability to perform assays or otherwise conduct our business.

If protection of the intellectual property underlying our technology and trade secrets is inadequate, then third parties may be able to use our technology or similar technologies, thus reducing our ability to compete.

We currently rely on certain technologies for which we believe patents are not economically feasible and therefore may be developed independently or copied by our competitors. Furthermore, we rely on certain proprietary trade secrets and know-how, which we have not patented. Although we have taken steps to protect our unpatented trade secrets and know-how, principally through the use of confidentiality agreements with our employees, there can be no assurance that these agreements will not be breached, that we would have adequate remedies for any breach, or that our trade secrets will not otherwise become known or be independently developed or discovered by competitors. If our trade secrets become known or are independently developed or discovered by competitors, it could have a material adverse effect on our ability to compete.

Our assays may infringe on the intellectual property rights of others, which may cause us to engage in costly litigation which may cause us to pay substantial damages and prohibit us from selling our assays.

Other companies or institutions engaged in assay development, including our competitors, may obtain patents or other proprietary rights that would prevent, limit or interfere with our ability to develop, perform or sell our assays. As a result, we may be found to be, or accused of, infringing on the proprietary rights of others. For example, in response to a patent infringement allegation from Athena Diagnostics in 1997, we ceased performing an assay used to diagnose late onset Alzheimer's disease. We have received letters from Chiron Corporation and the National Institute of Health in February 1998 and April 2000, respectively, claiming that some of our assays may violate their patents. The assays which may be affected by these claims comprised approximately $22.9 million of our net revenue for the year ended December 31, 2000. While management believes that none of these claims will have a material adverse effect on our business, there can be no assurance that there will be no adverse consequences to us. As a result of these claims and any other infringement related claims, we could incur substantial costs in defending any litigation, and intellectual property litigation could force us to do one or more of the following:

cease developing, performing or selling products or services that incorporate the challenged intellectual property;

obtain and pay for licenses from the holder of the infringed intellectual property right; or

redesign or reengineer our assays.

Any efforts to reengineer our assays or any inability to sell our assays could substantially increase our costs, force us to interrupt product sales, delay new assay releases and ultimately, reduce our revenues.

We may acquire other businesses, products or technologies in order to remain competitive in our market and our business could be adversely affected as a result of any of these future acquisitions.

We have made in the past and we may continue to make acquisitions of complementary businesses, products or technologies. In this regard, we recently acquired BBI Clinical Laboratories, Inc. Please see "Management's Discussion and Analysis of Financial Condition and Results of Operations Overview." If we identify any additional appropriate acquisition candidates, we may not be successful in negotiating acceptable terms of the acquisition, financing the acquisition, or integrating the acquired business, products or technologies into our existing business and operations. Further, completing an acquisition and integrating an acquired business will significantly divert management time and resources. If we consummate any significant acquisitions using stock or other securities as consideration, your equity in us could be significantly diluted. If we make any significant acquisitions using cash consideration, we may be required to use a substantial portion of our available cash. Acquisition financing may not be available on favorable terms, if at all. In addition, we may be required to amortize significant amounts of goodwill and other intangible assets in connection with future acquisitions, which would harm our operating results.

We may encounter problems or delays in operating or implementing our automated processing systems, which could disrupt our operations, require us to develop alternatives and increase our costs.

In order to meet growth in demand for our esoteric assays, we will have to process many more patient samples than we are currently processing. We have implemented a high-speed specimen sorting system known as the Total Accessioning Re-Organization System, or TARO . In addition, we plan to develop and implement other automated systems to enhance our testing procedures, including the implementation of a specimen splitting system. We will need to develop sophisticated software to support these other automated procedures, analyze the data generated by these tests and report the results. Further, as we attempt to increase the number of patient samples we process, throughput or quality-control problems may arise.

If we are unable to consistently process patient samples on a timely basis because of delays or failures in our implementation of these automated systems, or if we encounter problems with our established automated processes, we will be required to develop alternate means to process our business which may increase our costs.

Our operations and facilities are subject to stringent laws and regulations and if we are unable to comply, our business may be significantly harmed.

As a provider of healthcare-related services, we are subject to extensive and frequently changing federal, state and local laws and regulations governing licensure, billing, financial relationships, referrals, conduct of operations, purchases of existing businesses, cost-containment, direct employment of licensed professionals by business corporations and other aspects of our business relationships.

If we do not comply with existing or additional laws or regulations, or if we incur penalties, it could increase our expenses, prevent us from increasing net revenue, or hinder our ability to conduct our business. In addition, changes in existing laws or regulations, or new laws or regulations, may delay or prevent us from marketing our products or cause us to reduce our pricing.

Fraud and Abuse

Of particular importance to our operations are federal and state laws prohibiting fraudulent billing and providing for the recoupment of non-fraudulent overpayments, as a large number of laboratories have been forced by the federal and state governments, as well as by private payors, to enter into substantial settlements under these laws. Government investigations of clinical laboratories have been ongoing for a number of years and are expected to continue in the future. While written "corporate compliance" programs to actively monitor compliance with fraud laws and other regulatory requirements are recommended by the Department of Health and Human Services' Office of the Inspector General and are common in the clinical laboratory industry, we are only in the process of implementing such a program.

Federal and State Clinical Laboratory Licensing

The operations of our clinical laboratory are subject to a stringent level of regulation under the Clinical Laboratory Improvement Amendments. For certification under the Clinical Laboratory Improvement Amendments, laboratories such as us must meet various requirements, including requirements relating to quality assurance, quality control and personnel standards. Our laboratory is also subject to strict regulation by California, New York and various other states. We are accredited by the College of American Pathologists, and therefore are subject to their requirements and evaluation. Our failure to comply with Clinical Laboratory Improvement Amendments, state or other applicable requirements could result in various penalties, including loss of licensure, certification or accreditation. Such penalties could result in our being unable to continue performing laboratory testing. Compliance with such standards is verified by periodic inspections and requires participation in proficiency testing programs. No assurances can be given that our facilities will pass all future inspections conducted to ensure compliance with federal or any other applicable licensure or certification laws. Substantial expenditures are required on an ongoing basis to ensure that we comply with existing regulations and to bring us into compliance with newly instituted regulations.

Food & Drug Administration

Neither the FDA nor any other governmental agency currently fully regulates the new assays we internally develop. Although the FDA previously asserted that its jurisdiction extends to tests generated in a clinical laboratory, it has allowed these tests to be run and the results commercialized without FDA premarket approval. However, we cannot predict the extent of future FDA regulation and there can be no assurance that the FDA will not consider testing conducted at a clinical laboratory to require premarketing clearance. Hence, we might be subject in the future to greater regulation, or different regulations, that could have a material effect on our finances and operations.

Anti-Kickback Regulations

Existing federal laws governing Medicare and Medicaid and other similar state laws impose a variety of broadly described restrictions on financial relationships among healthcare providers, including clinical laboratories. These laws include federal anti-kickback laws which prohibit clinical laboratories from, among other things, making payments or furnishing other benefits intended to induce the referral of patients for tests billed to Medicare, Medicaid or certain other federally funded programs. In addition, they also include self-referral prohibitions which prevent us from accepting referrals from physicians who have non-exempt ownership or compensation relationships with us as well as anti-markup and direct billing rules that may apply to our relationships with our customers. Sanctions for violations of these laws may include exclusion from participation in Medicare, Medicaid and other federal healthcare programs, and criminal and civil fines and penalties.

Fee-Splitting

The laws of many states prohibit physicians from sharing professional fees with non-physicians and prohibit non-physician entities, such as us, from practicing medicine and from employing physicians to practice medicine. If we do not comply with existing or additional regulations,

or if we incur penalties, it could increase our expenses, prevent us from increasing net revenue, or hinder our ability to conduct our business. In addition, changes in existing regulations or new regulations may delay or prevent us from marketing our products or cause us to reduce our pricing.

If we do not comply with laws and regulations governing the confidentiality of medical information, it will adversely affect our ability to do business.

The confidentiality of patient medical information is subject to substantial regulation by the state and federal governments. State and federal laws and regulations govern both the disclosure and the use of confidential patient medical information. Most states have laws that govern the use and disclosure of patient medical information and the right to privacy. Similarly, many federal laws also may apply to protect such information, including the Electronic Communications Privacy Act of 1986 and federal laws relating to confidentiality of mental health records and substance abuse treatment.

Legislation governing the dissemination and use of medical information is continually being proposed at both the state and federal levels. For example, the Health Insurance Portability and Accountability Act of 1996 requires the U.S. Secretary of Health and Human Services to develop regulations to protect the security and privacy of individually identifiable health information that is electronically transmitted or received. In November 1999, the U.S. Secretary of Health and Human Services published proposed regulations under the Health Insurance Portability and Accountability Act of 1996 that would protect the privacy of individually identifiable health information that is transmitted or received electronically. Prior to that, the Secretary of HHS published proposed regulations relating to security of individually identifiable health information. When and if the security regulation becomes final, and if the privacy regulation is not modified by HHS or invalidated by Congress under the Congressional Review Act, then they will require that holders or users of electronically transmitted patient health information implement measures to maintain the security and privacy of such information. Ultimately, this and other legislation may even affect the dissemination of medical information that is not individually identifiable. Physicians and other persons providing patient information to us are also required to comply with these laws and regulations. If a patient's privacy is violated, or if we are found to have violated any state or federal statute or regulation with regard to the confidentiality, dissemination or use of patient medical information, we could be liable for damages, or for civil or criminal fines or penalties.

The commercialization of our Internet products including Outreach Express , DataPassportMD , and DataPassport Clinical Trials is strictly governed by state and federal laws and regulations, including the new and proposed regulations under the Health Insurance Portability and Accountability Act of 1996. We have implemented encryption technology to protect patient medical information, however, use of encryption technology does not guarantee the privacy and security of confidential information. We believe that we are in material compliance with all currently applicable state and federal laws and regulations governing the confidentiality, dissemination and use of medical record information. However, differing interpretations of existing laws and regulations, or the adoption of new laws and regulations, could reduce or eliminate our ability to obtain or use patient information which, in turn, could limit our ability to use our information technology products for electronically transmitting patient data.

Our net revenue will be diminished if payors do not authorize reimbursement for our services.

There has been and will continue to be significant efforts by both federal and state agencies to reduce costs in government healthcare programs and otherwise implement government control of healthcare costs. In addition, increasing emphasis on managed care in the United States may continue to put pressure on the pricing of healthcare services. Uncertainty exists as to the reimbursement status of new assays. Third party payors, including state payors and Medicare, are challenging the prices charged for medical products and services. Government and other third party payors increasingly are limiting both coverage and the level of reimbursement for our services. Third party insurance coverage may not be available to patients for any of our existing assays or assays we discover and develop. Third party payors accounted for approximately 7.4% of our net revenue in 1999 and 7.3% of our net revenue for the year ended December 31, 2000. However, a substantial portion of the testing for which we bill our hospital and laboratory clients is ultimately paid by third party payors and we do not know the percentage of our net revenue that is indirectly derived from these payors. Any pricing pressure exerted by these third party payors on our customers may, in turn, be exerted by our customers on us. If government and other third party payors do not provide adequate coverage and reimbursement for our assays, our net revenue may decline.

If a catastrophe were to strike our clinical laboratory facility, we would be unable to process our customers' samples for a substantial amount of time and we would be unable to operate our business competitively.

Our clinical and processing facility may be affected by catastrophes such as earthquakes or sustained interruptions in electrical service. Earthquakes are of particular significance to us because all of our clinical laboratory facilities are located in Santa Monica, California, an earthquake-prone area. In the event our existing clinical laboratory facility or equipment is affected by man-made or natural disasters, we would be unable to process our customers' samples in a timely manner and unable to operate our business in a commercially competitive manner. To

address these risks, we have in place formal recovery plans for all interruptions of service. This includes identification of alternate laboratory testing facilities and complete disaster recovery protocols. We also carry earthquake insurance with coverage amount of up to $10 million and have outsourced part of our data storage and processing equipment to a facility designed to withstand most earthquakes. Despite these precautions, there is no assurance that we could recover quickly from a serious earthquake or other disaster.

We rely on a continuous power supply to conduct our operations, and California's current energy crisis could disrupt our operations and increase our expenses.

All of our laboratory operations are located in Santa Monica, California. California is in the midst of an energy crisis that could disrupt our operations and increase our expenses. In the event power reserves for the State of California fall to critically low levels, California may implement rolling power blackouts throughout the State. The State of California has already experienced such occasional power blackouts. We currently have backup power generators for our laboratories in the event of a blackout. Our current insurance, however, does not provide coverage for any damages we may suffer as a result of any interruption in our power supply. If blackouts interrupt our third party power supply, we may be temporarily unable to continue operations. Any such interruption in our ability to continue operations would delay our processing of laboratory samples, disrupt communications with our customers and suppliers and delay product shipment. Power interruptions could also damage our reputation and could result in lost revenue. Any loss of power could have a material adverse effect on our business, operating results and financial condition. Furthermore, shortages in wholesale electricity supplies have caused power prices to increase. If wholesale prices continue to increase, our operating expenses will likely increase which will have a negative effect on our operating results.

Our quarterly operating results may fluctuate and this could cause our stock price to fluctuate or decline.

Our quarterly operating results have varied significantly in the past and may vary significantly in the future. If our quarterly net revenue and operating results fall below the expectations of securities analysts and investors, the market price of our common stock could fall substantially. Operating results vary depending on a number of factors, many of which are outside our control, including:

- demand for our assays and ancillary services;
- loss of a significant customer or group purchasing organization contract;
- new assay introductions by competitors;
- changes in our pricing policies or those of our competitors;
- the hiring and retention of key personnel;
- changes in healthcare laws and regulations; and
- costs related to acquisitions of technologies or businesses.

We plan to expand our sales and marketing, research and development and general and administrative efforts, which will lead to an increase in expenses. If our net revenue does not increase along with these expenses, our business, operating results and financial condition could be materially harmed and operating results in a given quarter could be worse than expected.

For a more detailed description of our operating results, please see "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Our stock price is likely to be volatile and could drop unexpectedly.

The price at which our common stock will trade is likely to be volatile. The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices of securities, particularly securities of clinical laboratory, biotechnology and other healthcare service companies. As a result, the market price of our common stock may materially decline, regardless of our operating performance. In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against that company. We may become involved in this type of litigation in the future. Litigation of this type is often expensive and diverts management's attention and resources.

We are controlled by a single existing shareholder, whose interests may differ from other shareholders' interests.

Our principal shareholder is Specialty Family Limited Partnership, whose sole general managing partner is our Chairman and Chief Executive Officer, Dr. James B. Peter. Specialty Family Limited Partnership, together with Dr. Peter, currently beneficially own approximately 70% of the outstanding shares of our common stock. Accordingly, the Specialty Family Limited Partnership along with Dr. Peter will have significant influence in determining the outcome of any corporate transaction or other matter submitted to the shareholders for approval, including election of directors, mergers, consolidations and the sale of all or substantially all of our assets. Our principal shareholder will also have the power to prevent or cause a change in control. The interests of this shareholder may differ from other shareholders' interests. In addition, this concentration of ownership may delay, prevent, or deter a change in control and could deprive other shareholders of an opportunity to receive a premium for their common stock as part of a sale of our business.

Anti-takeover provisions in our charter documents could prevent or delay a change in control and, as a result, negatively impact our shareholders.

We have taken a number of actions that could have the effect of discouraging a takeover attempt. For example, provisions of our amended and restated articles of incorporation and amended and restated bylaws could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. These provisions also could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

These provisions include:

- limitations on who may call special meetings of shareholders;
- advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings; and
- the ability of our board of directors to issue preferred stock without shareholder approval.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

Our exposure to market rate risk for change in interest rates relates primarily to our investment portfolio. In addition, our holdings are also exposed to the risks of changes in the credit quality of the issuer. At March 31, 2001, our holdings, which had an original maturity date of less than 90 days, were classified as cash and cash equivalents on our consolidated balance sheet. At March 31, 2001, we had cash and cash equivalents of $31.8 million, which had a weighted average yield of 6.35% per annum and an average of 39.41 days until maturity. At March 31, 2001, our short-term investment balance of $31.9 million, consisting of commercial paper and corporate bonds with maturity dates over 90 days and less than one year, had a weighted average yield per annum of 6.16% and an average of 165.36 days until maturity. At March 31, 2001, our long-term investment balance of $5.1 million consisted of corporate bonds with maturity dates beyond one year.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Previously reported on Form 10-K filed March 30, 2001.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a)

Reports on Form 8-K:

A Current Report, Form 8-K, dated February 20, 2001, was filed with the Commission, by the Registrant, in connection with a press release dated February 20, 2001 reporting the acquisition of certain assets of BBI Clinical Laboratories, Inc., a Massachusetts corporation, for $9,500,000 in cash.

A Current Report, Form 8-K, dated March 1, 2001, was filed with the Commission, by the Registrant, in connection with a press release dated March 1, 2001 announcing the appointment of John C. Kane to its Board of Directors.

A Current Report, Form 8-K, dated March 15, 2001, was filed with the Commission, by the Registrant, in connection with a press release dated March 15, 2001, announcing the signing of a three-year agreement with Novation.

A Current Report, Form 8-K, dated April 9, 2001, was filed with the Commission, by the Registrant, in connection with a press release dated April 9, 2001 electing Nancy-Ann DeParle to its Board of Directors.

(b)

Exhibits.

The following exhibits are filed as part of, or are incorporated by reference in, this Quarterly Report.

Number	Description
10.1	Supplier Agreement, dated March 5, 2001, between Novation and Registrant.

Confidential treatment requested and received as to certain portions of this agreement.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized.

SPECIALTY LABORATORIES, INC.,
a California corporation

Dated: May 15, 2001

By: /s/ JAMES B. PETER

Name: James B. Peter
Title: *Chief Executive Officer and Chairman of the Board of Directors*

Dated: May 15, 2001

By: /s/ FRANK J. SPINA

Name: Frank J. Spina
Title: *Chief Financial Officer (Principal Financial and Accounting Officer)*

EXHIBIT INDEX

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QuickLinks