

Office of the President

TO MEMBERS OF THE COMMITTEE ON HEALTH SERVICES:

ACTION ITEM

For Meeting of January 22, 2014

ESTABLISHMENT OF A JOINT VENTURE WITH CENTRE TESTING INTERNATIONAL, UCLA HEALTH SYSTEM, LOS ANGELES CAMPUS

EXECUTIVE SUMMARY

UCLA Health System proposes to form a Sino-foreign contractual joint venture company with Centre Testing International (CTI), a publicly traded Chinese company, for the purpose of developing and operating a 10,000-square-foot clinical laboratory in Shanghai, China. Under the terms of the proposed joint venture, CTI would be the majority stakeholder with 51-percent ownership. The Regents would have 49-percent ownership based on UCLA Health System's in-kind contribution of clinical laboratory managerial and service expertise.

RECOMMENDATION

The President recommends that the Committee on Health Sciences recommend that the Regents:

1. Approve the participation of UCLA Health System in a joint venture with Centre Testing International (CTI) to be named CTI-Pathology/UCLA Health to establish and operate a clinical laboratory in Shanghai, China, subject to the following conditions:
 - A. The company will be owned jointly by CTI and The Regents. CTI will have a 51-percent interest in the company and The Regents 49 percent. The Regents' contribution will be in-kind clinical laboratory management and services expertise. CTI will provide all capital needs for the joint venture as well as service functions, such as human resources and accounting. Except for the above-described contribution, The Regents will not be responsible for making any capital contributions to establish the laboratory or to participate in the joint venture.
 - B. The company shall be governed by a Board of Directors (Board). The Regents will appoint two members to the company Board through the Vice Chancellor and Dean of the David Geffen School of Medicine, UCLA. CTI will appoint three members to the Board.

- C. UCLA Health System will manage the laboratory on behalf of the University pursuant to management services agreements entered into by first UCLA Health System and an existing sub-unit of CTI, Shanghai CTI-Aipu Medical Laboratory Co., Ltd., and later between the new joint venture company and UCLA Health System.
 - D. The use of UCLA's name will be licensed to the new joint venture company for co-branding purposes in connection with operation of the laboratory, subject to a separately approved license agreement, which will be consistent with both California statutes and University of California policy.
 - E. Prior to the adoption by the new company, the initial formational documents, including but not limited to the articles of association, and any amendments thereto, shall be subject to the approval of the President following consultation with the General Counsel.
 - F. The Regents shall retain the right to terminate the agreement (i) in the event conversion to a contractual joint venture company does not occur within six months of the formation of the company; or (ii) in the event of any uncured material breach by CTI of its obligations to the University.
2. Authorize the President, following consultation with the General Counsel, to approve and execute (i) any documents reasonably required to participate in the joint venture as described above, including but not limited to a Framework Agreement, a Contractual Joint Venture Agreement, a License Agreement, and a Services Agreement; and (ii) any modifications, addenda, or amendments (collectively, "amendments") provided, however, such amendments do not materially reduce the rights of The Regents or materially increase the obligations of The Regents.

BACKGROUND

UCLA's international strategy was articulated in a white paper in 2009, endorsed by the David Geffen School of Medicine and UCLA Health System's leadership, establishing principles for international business development. It concluded that UCLA's international strategy should be based on a strong academic relationship with a small number of high-quality institutions in targeted geographies, with China appearing to offer the most significant opportunities. A faculty group was charged by the Vice Chancellor, Health Sciences to evaluate UCLA's international and global health work. That faculty group recommended a formal organization for UCLA's global efforts, resulting in 2011 in the establishment of the UCLA Center for World Health with the mission of improving the health of people and communities throughout the world through education, research, and service.

In its first report to the Vice Chancellor, Health Sciences the UCLA Center for World Health recognized UCLA's significant effort from 2009-2013 to establish an academic affiliation with Zhejiang University in Hangzhou, China, beginning with student and trainee exchanges and

expanding to Zhejiang's incorporation of the David Geffen School of Medicine's curriculum. The report also described the relationship with The Second Affiliated Hospital of Zhejiang University (SAHZU), which forms the foundation for development of the proposed laboratory in China.

UCLA and SAHZU began planning together to build a laboratory that could support the growing clinical trials work in China. Consultants were engaged, and a market analysis indicated a significant business opportunity with projected revenues of \$3 million within three years and profitability within five years. While developing a business plan for the laboratory, UCLA Health System was contacted by Centre Testing International (CTI), a Chinese-based, publically traded company that does consumer products testing. CTI was entering the laboratory business, had already been granted a difficult-to-obtain license to establish a laboratory in Shanghai, China, had leased space, and was looking for a U.S. academic partner to run the laboratory. UCLA Health System's earlier investigation of forming a laboratory affiliation in China provided a basis for evaluating CTI's business plan for the reference laboratory (Attachment 1). The laboratory is a sound business proposition. But more importantly, it will significantly enhance patient care in China. Currently, reliable and reproducible cancer testing, especially in the subspecialty areas of immunohistochemistry, molecular pathology, flow cytometry, and cytogenetics are not available in China.

The laboratory will create tremendous educational potential. The education of Chinese pathologists, technologists, residents, and students by UCLA experts will result in a higher level of expertise of the Chinese laboratory professionals and leadership, further solidifying the Sino-UCLA medical partnership. The laboratory will enhance UCLA's relationship with SAHZU, because UCLA's pathology department will be playing a significant advisory role in the CTI laboratory. The affiliation with an established Chinese company would enable UCLA to gain business experience in China and be positioned for other, potentially larger operations in the future.

Structure

The relationship between UCLA and CTI will be structured in two phases. CTI has established a limited liability entity in China to establish and operate a medical laboratory, Shanghai CTI-Aipu Medical Laboratory Co, Ltd. (CTI-Sub). In phase one, there will be a ten-year management, service, and licensing agreement whereby the University will provide services to CTI-Sub for establishing and operating the laboratory. This would include identifying a laboratory Medical Director, training staff, and identifying equipment to enable the laboratory to be running by July 1, 2014..

Phase two will convert the CTI-Sub into a Sino-foreign contractual joint venture company (CJV) in which the University will own a 49-percent interest and CTI will own a 51-percent interest. The conversion to the CJV requires Chinese governmental approval and is expected to be completed by early 2014.

The University will not be responsible for making any cash contributions for establishing the laboratory or in connection with forming the CJV. CTI will be responsible for providing all cash contributions to the CJV. As of the date of this submission CTI has contributed approximately \$4.9 million to CTI-Sub and anticipates a total of \$6.4 million to fully capitalize the operation.

After the CJV conversion, the University will be entitled to 49 percent of the profit distribution in the CJV. Prior to the CJV conversion, the University will receive 49 percent of the profit distribution in CTI-Sub in the form of a license fee under the License Agreement. In addition, before and after the CJV conversion, CTI will pay the University an annual fee of \$75,000 and reimburse the University for all direct and indirect training costs and honoraria of the University's personnel in connection with providing services under the Service Agreement, subject to applicable conflict of interest rules.

Should the CJV conversion not be approved by the government, and The Regents choose not to terminate the agreement (as discussed below), the relationship of UCLA to CTI and the laboratory will continue to be defined by the licensing and service agreements, whereby UCLA would provide management services to the laboratory as in phase 1.

For the purpose of establishing and operating the laboratory, ownership interest in the laboratory is preferable and generally viewed as having less enforceability risk than a contractual relationship with the owner of the laboratory.

Management and Governance

The business of the CJV will be conducted by a Board of Directors comprised of five members, with three appointed by CTI and two appointed by the University. Certain major decisions enumerated in the CJV Agreement, such as changes in registered capital, sale of the company, annual budget and operating plans, or appointment of directors, require the unanimous approval of the Board. All other decisions by the Board can be made by majority vote. All resolutions made at Board meetings must be confirmed in writing and records maintained. Similarly, the License Agreement requires CTI-Sub to maintain complete records of CTI-Sub's business. The Board will appoint a Managing Director who will prepare annual business plans and budgets and with the Board's approval, will manage the day-to-day operations in implementing the business plan. There will also be a Chief Financial Officer nominated by the University who will be an authorized signatory for the CJV's bank accounts to control and monitor the flow of funds of the CJV. The University will appoint the CJV's Medical Laboratory Director, who will be the sole employee of the University in the CJV.

The CJV's financial reporting must be undertaken in accordance with international standards and the accounting rules adopted by the CJV must be approved by the University. In addition, the Board will also appoint an independent auditor who will review and audit the CJV's financial reports.

The laboratory will be designed, staffed, and equipped to meet the highest Chinese and international regulatory and compliance standards for medical laboratories. When the laboratory

is fully staffed and all necessary licenses have been obtained, it will meet all accreditation standards of the United States College of American Pathologists.

University Oversight

The University will be represented on the CJV Board by two individuals who will be appointed by the Vice Chancellor and Dean of the David Geffen School of Medicine. Those individuals will report to the Vice Chancellor or his designee.

The assurance that the laboratory is run according to standards will be the responsibility of the UCLA Senior Vice Chair and Director of Pathology Laboratory Services, who reports to the Chairman of the UCLA Department of Pathology. The laboratory management will report to the Chief Administrative Officer in the UCLA Department of Pathology who, in turn, reports to the Senior Vice Chair and Director of Pathology Laboratory Services and to the UCLA Health System Chief Operating Officer as do the other laboratories in the UCLA Health System .

Quarterly reports on the development and function of the laboratory will be provided by both the Board members and management to the Vice Chancellor as well as to the Executive Committee of the UCLA Center for World Health, which has been designated as the body that evaluates international initiatives.

Financial Impact and Risks

This joint venture has little or no downside financial risks to the University, since cash investment is from CTI. Instead of making cash contributions, the University will provide management expertise and clinical laboratory services in exchange for its 49-percent ownership interest. UCLA Health System's laboratory services and Department of Pathology will be compensated for any and all of its costs associated with development and management of the Laboratory.

There are unknown risks to doing business in China. UCLA has done due diligence to evaluate CTI as a partner. It engaged legal counsel in China, who understand and can advise the University on business law and practices. Clauses articulating compliance with anti-graft laws in China are prominent in the agreements. An independent audit of the company will be done annually. The David Geffen School of Medicine at UCLA and the UCLA Health System have a long and trusted relationship with Zhejiang University and the leadership of its Second Affiliated Hospital.

In the development of the UCLA Center for World Health, it was clear that the reputation of academic medical centers is becoming global. It is insufficient to have only a national reputation, and will be increasingly necessary to have an international reputation to recruit the best faculty and students and to compete for grants and patients. The establishment of this laboratory is an important step in enhancing the University's reputation in China. Probably the biggest risk is that if the affiliation were unsuccessful, it could harm UCLA's reputation and thereby its strategy in China and Asia.

The CJV conversion will require a new license for the establishment of a foreign-invested laboratory. However, because there is a quota in each district in Shanghai on the number of licenses to establish laboratories, there is no guarantee that the CJV conversion will be approved. To mitigate such risk, the Framework Agreement, which includes all terms and provisions of the CJV Agreement, will allow the University to participate in the management and operation of CTI-Sub as if it were an owner based on a contractual arrangement before the CJV conversion. In addition, to limit the University's commitment, the University has the option to terminate the Framework Agreement and the parties' cooperation if the CJV conversion is not achieved within six months of the execution of the Framework Agreement.

Competition

During the term of the Service Agreement, except for the University's existing cooperation program with the Second Affiliated Hospital of Zhejiang University School of Medicine and the establishment of a genomics lab in China, the University may not enter into any identical arrangements with CTI-Sub's direct competitors in China for laboratory management services of the kind provided for in the Service Agreement. These restrictions are to be narrowly construed and do not limit affiliates of the University from entering into agreements with, or providing clinical services to, hospitals and health systems in China. Similar non-competition restrictions apply to CTI-Sub, except that the SAHZU School of Medicine may serve as an alternative source for second opinion consultation via glass slides or digital images and may provide support for testing and staffing purposes should the need arise. The CJV Agreement states that the exclusivity applies only to the UCLA Health System, and does not bind other entities of The Regents, nor does it bind other academic components of UCLA.

Termination

The Framework Agreement may be terminated at the option of the University if the necessary approvals for conversion to the CJV are not obtained within six months. If the University makes such an election to terminate the Framework Agreement, the Service Agreement and License Agreement will also be terminated. With the exception of indemnification and confidentiality obligations, which shall continue indefinitely, the University will have no obligations under the agreements once the agreements are terminated. Alternatively, the Framework Agreement could remain in place with UCLA compensated under its terms to manage the laboratory.

If the CJV were to be dissolved after the conversion is approved and the CJV Agreement comes into effect, a liquidation committee comprised of four individuals, with two appointed by CTI and two appointed by the University, would formulate liquidation procedures in accordance with law of the People's Republic of China.

With respect to staffing, the University will be responsible only for making employee recommendations and approvals to CTI-Sub and has no obligations to pay for the compensation of CTI-Sub or, upon conversion, CJV employees.

(Attachment)

Attachment 1

CTI - UCLA Joint Venture Laboratory- China

Income Statement--conservative market growth case

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
<i>Units: US\$</i>						
Capitalization	\$6,400,000					
Revenue	\$566,400	\$1,208,000	\$1,926,400	\$3,110,400	\$4,387,200	\$5,264,000
COGS	\$144,000	\$308,800	\$494,400	\$806,400	\$1,142,400	\$1,371,200
Gross Revenue	\$422,400	\$899,200	\$1,432,000	\$2,304,000	\$3,244,800	\$3,892,800
Expenses						
Equipments and Buildput	\$3,000,000					
Sales and Marketing	\$385,600	\$385,600	\$385,600	\$622,400	\$876,800	\$1,052,800
Salaries and Benefits	\$1,067,200	\$1,120,000	\$1,288,000	\$1,454,400	\$1,528,000	\$1,824,000
Repairs and Maintenance	\$108,800	\$108,800	\$108,800	\$108,800	\$108,800	\$150,400
Utilities and other expense	\$27,200	\$41,600	\$56,000	\$80,000	\$107,200	\$126,400
Total Expenses	\$1,588,800	\$1,656,000	\$1,838,400	\$2,265,600	\$2,620,800	\$3,153,600
EBITDA	(\$1,166,400)	(\$756,800)	(\$406,400)	\$38,400	\$624,000	\$739,200
Depreciation & amortization	\$225,600	\$225,600	\$225,600	\$225,600	\$308,800	\$308,800
EBIT	(\$1,392,000)	(\$982,400)	(\$632,000)	(\$187,200)	\$315,200	\$430,400
Tax	-	-	-	-	\$41,600	\$64,000
Net income	(\$1,392,000)	(\$982,400)	(\$632,000)	(\$187,200)	\$273,600	\$366,400
Capital Reserve	\$3,400,000	\$2,008,000	\$1,025,600	\$393,600	\$206,400	\$480,000