Quest Diagnostics Incorporated
Conference Call Prepared Comments
For the Quarter Ended September 30, 2013

Conference operator: Welcome to the Quest Diagnostics Third Quarter 2013 conference call. At the request of the company, this call is being recorded. The entire contents of the call, including the presentation and question and answer session that will follow, are the copyrighted property of Quest Diagnostics with all rights reserved. Any redistribution, retransmission or rebroadcast of this call in any form without the express written consent of Quest Diagnostics is strictly prohibited. Now I'd like to introduce Dan Haemmerle, Executive Director of Investor Relations for Quest Diagnostics. Go ahead, please.

Dan Haemmerle: Thank you and good morning. I am here with Steve Rusckowski, our president and chief executive officer, and our new CFO, Mark Guinan. In addition, our senior vice president and chief medical officer, Dr. Jon Cohen, will join us for Q&A.

During this call, we may make forward-looking statements. Actual results may differ materially from those projected. Risks and uncertainties that may affect Quest Diagnostics' future results include, but are not limited to, those described in Quest Diagnostics' 2012 Annual Report on Form 10-K and 2013 Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

A copy of our earnings press release is available, and the text of our prepared remarks will be available later today, in the Investor Relations "quarterly updates" section of our website at www.questdiagnostics.com.

A PowerPoint presentation and spreadsheet with our results and supplemental analysis are also available on the website.

Now, here is Steve Rusckowski.

Steve Rusckowski: Thanks, Dan. And thanks, everyone, for joining us today.

I'll take you through the top-line performance; share our thoughts on utilization and reimbursement trends as well as review progress against our five-point strategy. Then Mark will provide detail on the results.

First, clearly our third quarter performance was disappointing. We recognize that we have missed expectations this year, and revised our guidance more than once. We understand it is extremely important to achieve expectations, and we are focused on improving our predictability.

Our current view reflects two changes – the impact of a softer market than we had originally expected; and the fact that our strategy to Restore growth is taking longer to produce results.

Before commenting further, I'd like to welcome Mark Guinan, our new CFO. Mark brings strong financial operations experience to Quest providing us with a fresh perspective on how we can improve our performance and predictability.

Mark and I are already deeply engaged in driving shareholder value by executing our five-point strategy.

Now, let's turn to the market dynamics.

All year we had been saying that we anticipated continued revenue softness in the first half of this year, and that our efforts to restore growth would result in gradual improvement during the back half of the year. Although we have seen a gradual improvement in the performance versus the prior year, our third quarter performance was less than we expected. As a result, we fell short of expectations for the period by approximately $50 million.

As we have all seen in commentary from industry stakeholders, including hospitals, physicians, payers, suppliers and competitors, the healthcare industry overall is facing utilization headwinds.

- At the start of this year, our expectation was that 2013 would have about the same level of utilization we saw in 2012.
- In the first half we saw clear signs that healthcare utilization had declined versus last year, and at this point it appears this trend continued. As we reported to you last week, despite seeing some hopeful signs early in the quarter, volume softened late in the quarter.
- Overall, despite the soft finish to the quarter, volumes remained in line with our previous run rate as organic volumes, adjusted for business days was lower than the prior year by approximately 2%.

As I said earlier, in addition to the continued soft market, our initiatives to restore growth that we had planned to contribute in the quarter are taking longer to show results.

Additionally, this industry also faces considerable and ongoing pressure on reimbursement. In 2013, reimbursement challenges have become much more pronounced due to:

- Reductions in Medicare payments of approximately 5%;
- Cuts to the pathology codes on the Medicare physician fee schedule;
- Changes to Medicare fee schedules and coding requirements for molecular diagnostics; and, finally,
- The effects of renewed commercial payer contracts.

These changes just this year contributed to the lowering of our underlying revenue per requisition by 3.3% in the third quarter compared to 2012, and we now expect underlying revenue per requisition, before acquisitions, to be down a similar percentage for the full year. On a full year basis our price erosion will be greater than $200 million in 2013.

Also, our industry trade group has been fighting additional cuts that have been proposed or discussed, including:

- A measure to extend the fixed rate reduction of the Clinical Lab Fee Schedule through 2023 – as mentioned in the President's budget proposal in April.

- CMS's proposed significant changes to the Physician Fee Schedule, and a mechanism to adjust the Clinical Lab Fee Schedule in the future – as reported in July.

We are operating in a challenging environment. At the same time, we are making many changes to the way we operate. Together, these factors have affected our progress to restore growth.

Now I'd like to update you on our efforts and the progress we are making executing our five point business strategy.

- **Let's start by looking at how we are refocusing on diagnostic information services.**
  - We have made significant progress on our portfolio review.
  - Since late last year, we have sold our OralDNA dental diagnostics business, HemoCue diagnostic products business, Ibrutinib royalty rights and, most recently, Enterix, generating gross proceeds of approximately $800 million, providing flexibility to drive shareholder value.

- **Our portfolio review is helping us deliver disciplined capital deployment.**
  - Our commitment is to return the majority of our free cash flow to our shareholders.
    - During the quarter, we increased our share repurchase authorization by $1 billion.
    - In September we entered into an accelerated share repurchase agreement to repurchase approximately $350 million of our shares.
    - Year to date, we have deployed nearly $1 billion into share repurchases.
  - In addition, our goal is to generate 1-2% revenue growth per year through strategically aligned, accretive acquisitions.
  - So far we have completed four acquisitions, including the lab outreach businesses of UMass and Dignity Health as well as Concentra's toxicology business and, most recently, ConVerge.
    - Our first three acquisitions are on track and contributed 2% to revenues in the third quarter.
    - In October we completed the acquisition of ConVerge, our second this year in the New England market.

- **We're making progress driving operational excellence.**
  - With Invigorate, we are on track to realize more than $250 million in savings this year and remain committed to our goal of $600 million in run-rate savings next year and $1 billion beyond 2014.
  - This strategy, in addition to making us more efficient, will also allow us to improve our customer experience.

- **We are building the capabilities we need to restore growth.**
  - Our commercial reorganization is complete. As we have said, restoring growth is a gradual process, and takes time.
  - We have made investments in our clinical franchises and our laboratory professional services business. These investments are critical to helping us to restore growth.
    - The clinical franchises are beginning to deliver new solutions to meet customer needs and will help us grow esoteric and advanced diagnostic solutions.
    - For example, we are very excited to introduce BRCAvantage, a new choice in BRCA testing, that's intended to significantly broaden patient and provider access to testing for BRCA gene mutations associated with increased risk of inherited breast and ovarian cancers.

    - Quest's BRCAvantage is based on next-gen sequencing technology, an expertise in cancer, genetics and women's health matched by none, and a service-rich approach designed to deliver a better health care experience for the patient and clinician.
  - The laboratory professional services team continues to expand its pipeline of hospitals and integrated delivery networks that are interested in working with us to improve outcomes and reduce costs.

- **We also continue to Simplify the organization and build a new culture so we can improve our operations and grow.**
  - We built a new organizational structure that better serves our customers by removing complexity, speeding decision making and empowering employees.
  - We introduced new behaviors that will make us more agile, customer-focused, transparent, collaborative and performance oriented.
  - This week's launch of BRCAvantage demonstrates the power of our new organization and culture. Our Cancer clinical franchise team worked collaboratively with colleagues across our enterprise as well as externally with customers, suppliers and key opinion leaders to quickly develop and introduce this important solution. We're looking forward to launching many more successful solutions in the future.

While we are in a difficult operating environment, we are taking the right actions to make our company a stronger and more effective competitor. We are making progress, and recognize that there is much more to do.

Now I'll turn it over to Mark for detailed analysis of the numbers.

Mark Guinan: Thanks.

Steve, as you and I have discussed, I have several priorities for the Finance function. These include improving our predictability and supporting the business to achieve our five point strategy, starting with improving operations and restoring growth.

I can assure the investment community that I recognize the importance of delivering on guidance and we will instill the discipline to improve our predictability. I don't like surprises and recognize that investors like them even less than I do.

Turning to revenues…

Q3 consolidated revenues of $1.79 billion were 1.9% below the prior year.

Diagnostic Information Services revenues, which account for over 90% of total revenues, were 2.4% below the prior year. Volume was better than the prior year by 2%. Our first three acquisitions completed this year (UMass, Dignity Health and Concentra's toxicology business) contributed approximately 2% in the quarter to revenues and approximately 3% to volume – in line with expectations. Volume also benefited by approximately 1% due to favorable business days. Underlying volume, excluding business days and acquisitions, was lower by approximately 2%. As we have shared previously, we expected this year to be a building year and we expected to build momentum and show improvement later in the year.

Revenue per requisition in Q3 was down 4.3% compared to the prior year. The impact of our two second quarter acquisitions, principally Concentra's toxicology business, lowered revenue per requisition by approximately 1% in the quarter, resulting in a decrease in underlying revenue per requisition of approximately 3.3%. While under pressure all year from government and commercial payers, reimbursement was also impacted this quarter by increased denial rates and unfavorable test mix, both of which are related to molecular tests and coding changes made this year.

Q3 revenues in our Diagnostic Solutions businesses, which include risk assessment, clinical trials testing, healthcare IT, and our remaining products businesses, were favorable to the prior year by 4.1%.

Adjusted operating income was 16.5% of revenues, about 260 basis points below the prior year, with the decrease principally due to lower revenues. A significant portion of the lower revenue is being offset by continued progress with our Invigorate initiative. However, we are operating in an environment in which we continue to make investments in advance of the revenues we expect. For example, we are investing in clinical franchises in areas like cancer and women's health to develop and launch solutions like BRCAvantage. We are also making investments in our lab professional services offering, which is an important element of our long term strategy to restore growth. We expected volume growth in the current year to fund some of these investments. While they haven't, we have not slowed down the pace of investing.

Also, keep in mind, that Invigorate includes volume-based productivity improvements. While we remain confident we will deliver $250 million or more in the current year, the volume decline we've experienced has prevented us from realizing even more of the productivity savings we had expected.

Adjusted EPS of $1.02 was $0.13 below the prior year, with the decrease principally due to lower revenues, partially offset with cost savings realized from Invigorate and the benefits of our share repurchase program.

As a result of the company's ongoing efforts to drive operational excellence and simplify the organization, restructuring and integration costs of $39 million reduced reported operating income as a percentage of revenues by 2.2% and reported EPS by 16 cents. Last year's third quarter included $44 million of costs associated with restructuring and integration charges, which reduced reported operating income as a percentage of revenues by 2.4% and reported EPS by 17 cents.

Bad debt expense as a percentage of revenues was 3.6%, or 30 basis points higher than the prior year. The increase can be partially attributed to benefit plan design, as patients shoulder an increasing portion of health care costs. DSOs were 48 days, essentially unchanged from the second quarter.

Cash from operations was $186 million in the quarter compared to $395 million in the prior year. This is principally due to the following factors:

- Adjusted operating income lower by $54 million;
- Higher cash in the prior year period due to a non-recurring $72 million cash receipt upon termination of an interest rate swap agreement;
- Increase in size and timing of tax payments of $38 million in 2013; and
- Higher restructuring and integration payments in 2013 of $15 million.

Capital expenditures were $51 million in the quarter, compared to $45 million a year ago.

During the quarter we repurchased 7.2 million common shares. So far this year, we've repurchased almost $1 billion of our stock.

Turning to guidance:

We are updating guidance based on our performance year to date, the current operating environment which we do not expect to materially improve and based on updates from our business leaders. We expect full year 2013 results from continuing operations, before special items, to be as follows:

- Revenues to be approximately 3.5% below 2012. Prior guidance was to be 1% to 2% below the prior year level;
- Earnings per diluted share to be between $3.85 and $3.95, compared with prior guidance of $4.35 to $4.50;
- Cash provided by operations to approximate $850 million, compared to prior guidance that it would approach $1 billion;
- And capital expenditures, unchanged, to approximate $250 million.

Now I'll turn it back to Steve.

Steve Rusckowski: Thanks, Mark.

To summarize:

2013 is a building year for Quest.

- We are focused on implementing our five point strategy in a challenging environment, with a particular emphasis on our strategies to restore growth.
- We will continue to improve our execution.
- Our recent BRCAvantage launch demonstrates Quest's ability to empower better health with diagnostic insights, and this illustrates a great example of how our innovation will help us restore growth.
- Despite the current tough environment, we believe we operate in a very attractive market and our five point strategy positions Quest to deliver superior shareholder value.

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