Quest Diagnostics Incorporated
Conference Call Prepared Comments
For the Quarter Ended December 31, 2013

Conference operator: Welcome to the Quest Diagnostics Fourth Quarter and Full Year 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 Mark Guinan, our Chief Financial Officer.

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; update you on utilization and reimbursement trends; and review progress against our five-point strategy. Then Mark will provide more detail on the results and walk you through guidance.

We always said 2013 would be a building year and it was.

We have made good progress. During the quarter:

- Adjusted earnings per share increased 2% from 2012;
- Volume increased 2.3%; and
- Sequential year-over-year trends improved for revenue, volume and revenue per requisition.

I'd like to discuss the evolving industry dynamics. Lately there has been a lot of discussion about headwinds this industry is facing, specifically from utilization and reimbursement pressure. We identified and discussed these at our Investor Day more than a year ago and have provided periodic updates.

I'd like to remind you of what we've said and share our perspective on the market.

- First, it's clear to us that healthcare utilization declined broadly in 2013, and it is conceivable that this trend could continue in 2014 based on an acceleration of employer-to-employee cost-shifting in benefit plan design.
- Second, in terms of the expected market growth from the Affordable Care Act, it's now clear that the benefits will take longer to realize based on the slower rollout.
- Third, as we said in 2012, we continue to expect reimbursement to decline 1-2% per year on average from 2013 through 2015.

Given this guidance, we now expect revenues to be flat to down 2% for 2014, excluding the impact of Solstas. In a few minutes, Mark will share color on the 2014 guidance we introduced this morning.

We continue to be bullish on longer term growth drivers for this industry:

- The market will benefit from continued population growth and favorable demographics as Baby Boomers move into Medicare and live longer;
- Esoteric testing will grow as precision medicine drives demand for advanced esoteric tests;
- Despite the slow uptake from the Affordable Care Act, more insured lives will gradually begin to enter the market each year;
- And then, finally, medical guideline changes drive physician behavior, and we expect to see increases in some tests, such as Hepatitis C.

Over the long term, we see significant opportunity in being a high quality, low cost provider of diagnostic information services, which are essential to healthcare delivery.

We remain committed to executing our five-point strategy, and I'll give you an update on progress.

Our top priority for 2014 is to restore growth.

I am very pleased that our planned acquisition of Solstas Lab Partners is expected to contribute approximately 5% to consolidated revenues on an annualized basis and strengthen our presence in an important region of the country. And it will provide Solstas customers with access to Quest's full menu of esoteric testing and our industry leading Care360 connectivity solutions. As you know, our planned acquisition of Solstas is dependent upon necessary regulatory review.

Our five-point strategy committed us to refocusing on diagnostic information services. Since our Investor Day we divested four assets, yielding about $800 million in proceeds, and acquired four organizations which supported our goal, to generate 1-2% revenue growth per year through strategically aligned, accretive acquisitions. The Solstas transaction meets our stated investment criteria.

One way of looking at Solstas is as multiple fold-in acquisitions spread across nine states. Also, this combination strengthens our Laboratory Professional Services organization.

We see lab professional services as an important part of our growth strategy. After building our capabilities and pipeline over the past year, we are now pleased to announce that we have reached agreement with three hospital systems on lab professional services arrangements. While we are excited about these opportunities, they do take time to implement, and therefore we do not expect to see topline benefits before late in the second quarter, and this is built into our guidance.

Innovation is another key element of our strategy to restore growth.

Our new clinical franchises organization is helping us focus on serving market needs and filling gaps in care. I'd like to share two examples of progress we made during the quarter.

- First, we introduced our BRCAvantage test during the fourth quarter.
- Second, we created a partnership with UCSF, one of the country's top academic medical centers. Our organizations are collaborating to turn UCSF's biomedical research into advanced diagnostics in autism, oncology, neurology and women's health.

Our new franchise model is enabling us to act like a focused boutique laboratory while maintaining the advantages of our scale.

We continue to make progress driving operational excellence.

Our Invigorate cost-reduction initiative ended the year ahead of expectations with more than $250 million in realized savings in 2013. We also exited the year with run-rate savings of more than $500 million, surpassing the original Invigorate goal established in 2011 a year earlier than planned.

This positions us to exceed our $600 million goal in run-rate savings by the end of 2014, compared to 2011. We now anticipate run-rate savings approaching $700 million. And we also continue to be committed to our longer-term goal of $1 billion in savings beyond 2014.

As we have said, the operational excellence program, which we call Drive, is improving our quality and efficiency and will enable us to improve our overall customer experience.

We simplified the organization and we are building a new culture so we can improve our operations and grow.

- We are deploying a new set of behaviors and are becoming more external and customer-focused, as evidenced by the growing number of new partnerships like Hologic, UMass and UCSF.

We continue to deliver disciplined capital deployment.

- As we shared last year, our plan is to return the majority of our free cash flow to our shareholders through a combination of dividends and share repurchases.
- We met those commitments this year and announced earlier today that we have increased our dividend by 10%, this is our third increase since 2011.

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 be done.

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

Mark Guinan: Thanks, Steve.

Good morning. As I discussed in the third quarter call, I am focused on improving our predictability and supporting the business to achieve our five point strategy. I am pleased with our performance and pleased that we exceeded top and bottom line expectations. Our commitment remains to provide you with guidance that we believe is realistic and achievable.

Let me now turn to our fourth quarter performance…

Beginning with revenues…

Fourth quarter consolidated revenues of $1.76 billion were 1% below the prior year.

Diagnostic Information Services revenues were 0.7% below the prior year. Volume was better than the prior year by 2.3%, including a benefit of acquisitions, and our underlying volumes were lower by approximately 0.5%.

Revenue per requisition in Q4 was down 3% compared to the prior year. Our second quarter acquisitions, principally Concentra's toxicology business, reduced revenue per requisition by approximately 1% in the quarter. As we expected, underlying revenue per requisition year-over-year comparisons improved as certain commercial contract changes anniversaried. Our underlying revenue per requisition was lower than the prior year by approximately 2% in the fourth quarter. And on a full year basis, underlying revenue per requisition was lower than the prior year by approximately 3%, as we guided at the start of the year.

I also want to address some specific business mix issues in the Diagnostic Information Services business:

- During the quarter, we did not see a material change in reimbursement or denial rates on Molecular Diagnostics codes from what we had been seeing earlier in the year.
- We saw strong improvements throughout the year in our toxicology and wellness businesses.
- In 2013 our anatomic pathology revenues were lower, principally due to softer volumes, including the impact of guideline changes on our pap business, and reduced reimbursement, principally from CMS.

Turning to our Diagnostic Solutions business, Q4 revenues were unfavorable to the prior year by 4.2%, largely due to softness in our clinical trials business.

For the quarter, adjusted operating income was 16.1% of revenues, about 90 basis points below the prior year, with the decrease principally due to lower revenue per requisition. A significant portion of the lower revenue is being offset by continued progress with our Invigorate initiative, as Steve mentioned earlier.

Adjusted EPS of $1.03 was $0.02 better than the prior year and better than our guidance of $0.93 - $0.98.

As a result of the company's ongoing efforts to drive operational excellence and simplify the organization, restructuring and integration costs of $12 million reduced reported operating income as a percentage of revenues by 0.8% and reported EPS by 6 cents. Last year's fourth quarter included $36 million of costs associated with restructuring and integration charges, which reduced reported operating income as a percentage of revenues by 2.1% and reported EPS by 14 cents.

Bad debt expense as a percentage of revenues was 3.7%, or 30 basis points higher than the prior year. The higher bad debt was driven by payer mix, as changes in employer benefit plan design continue to shift costs to patients through co-insurance and higher deductibles. We expect that trend to continue.

Despite that trend, bad debt was stable-to-improved for every payer type; and the biggest improvement was related to cash collections from patients. This achievement is the result of dedicated effort in our "Drive" operational excellence program. DSOs were approximately 47 days, an improvement of one day from the third quarter.

Adjusting for the ibrutinib tax payment in the quarter of $175 million, our adjusted cash from operations was $385 million in the quarter compared to $380 million in the prior year.

Capital expenditures were $76 million in the quarter, compared to $60 million a year ago, with the increase related to additional spending to support our Invigorate initiatives and the investment in our new Lab of the Future in Marlborough, Mass.

During the quarter we repurchased 1.9 million common shares for approximately $113 million. For the full year, we have repurchased more than $1 billion of our stock and we have approximately $828 million remaining on our share repurchase authorization.

Turning to guidance for 2014.

We are expecting results from continuing operations, before special items and the benefit of the planned acquisition of Solstas, as follows:

- Revenues to be flat to down 2%, compared to 2013;
- Earnings per diluted share to be between $3.90 and $4.10;
- Cash provided by operations to approximate $900 million;
- And capital expenditures to approximate $300 million.

Let me share a few comments about our assumptions.

- On Solstas, we have not included a benefit in our forecast at this time. However, we expect that it could contribute approximately 3-4% to revenues this year and approximately five to 10 cents to adjusted earnings per diluted share, depending on the timing of the close, which at this point we anticipate in the second quarter. We expect to finance this deal with debt. We've targeted a long-term debt-to-EBITDA ratio of between 2 and 2.25 and therefore our intent is to pay down a majority of this debt over the next 18 months.

- Just to be clear, the guidance of flat to down 2% does not include Solstas. However, assuming we close Solstas in the second quarter, that would imply guidance of 2014 revenue growth of somewhere between 1% to 4%.
- Related to the Affordable Care Act, we have signaled for the past few quarters that we are expecting a muted impact from the Affordable Care Act in 2014 due to the delay of the employer mandate, a reduction in the number of states that have decided to expand their Medicaid programs, and initial challenges related to the implementation of the insurance exchanges. Additionally, we continue to see an increase in the amount of cost sharing deployed through benefit design changes, which will put pressure on utilization and bad debt. As a result, we believe the Affordable Care Act will be neutral to slightly positive in 2014; but we still expect to see a bigger benefit over the long run beyond 2014.

- On reimbursement, CMS reduced the Clinical Lab Fee schedule by 0.75% in January. The Physician Fee Schedule was also reduced in January by CMS. In addition, commercial reimbursement pressure continues, although we expect fewer negotiations in 2014 than in 2013.
- As we shared earlier, we reached agreement on 3 new lab professional services partnerships during the past few weeks. We expect them to be implemented later in the second quarter of this year and provide some volume lift as we head to the back half of the year. However, keep in mind, they generally carry lower margin than our traditional business.
- On Invigorate, we are expecting approximately $200 million in realized savings this year. These savings will help offset price erosion; inflation in our wage bill; and annual incentive compensation.
- And finally, as you build your models, I want to remind you that the sequestration reimbursement cut will not annualize until the end of the first quarter. I also want to note that the unusual cold, and snow and ice storms this month have negatively impacted our business. This impact has been taken into account in the full year guidance, but obviously is fully contained in Q1.

2014 has been a challenging year to model, with more operational variables in play than the normal year. In the short term there are pressures on our industry. However, based on our scale, new organizational structure, and progress we are making on our 5 point strategy, we believe we have a good plan that positions us well for the longer term.

…..Now I'll turn it back to Steve.

Steve Rusckowski: Thanks, Mark.

To summarize:

- 2013 was a building year for Quest.
- We had sequential improvement in the fourth quarter, and we continue to make good progress.
- Despite the current tough environment, diagnostic information services remain critical to healthcare delivery, and we believe this industry is attractive.
- We have the right strategy to help us navigate the challenges and deliver superior shareholder returns.