Quest Diagnostics Incorporated
Conference Call Prepared Comments
For the Quarter Ended December 31, 2014

Conference operator: Welcome to the Quest Diagnostics Fourth Quarter and Full Year 2014 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 and also discuss non-GAAP measures. 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' 2013 Annual Report on Form 10-K, quarterly reports on Form 10-Q and Current Reports on Form 8-K.

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.

This morning, I'll provide you with highlights of the quarter, share industry trends, and also review progress we are making executing on our five-point strategy. Then Mark will provide more detail on the results and take you through guidance.

We continued to make progress on our path forward, delivering solid revenue and EPS growth in the fourth quarter and the full year.

In the quarter:
- Revenues grew 7% to $1.9 billion;
- Adjusted EPS increased 5% to $1.08; and
- Cash from operations was strong at $303 million.

For the full year 2014:
- Revenues grew 4% to $7.4 billion;
- Adjusted EPS increased 2.5% to $4.10 a share; and
- We generated $938 million in cash.

Our performance reflects improved execution and a stable business environment. That, combined with our ability to generate substantial and predictable cash flow, has enabled us to raise our quarterly dividend 15% to 38 cents a share. This is the fourth time we've raised the dividend since 2011.

Before I get to our performance, I'd like to talk about industry dynamics for utilization, reimbursement and regulation.

- We continue to see signs of a modest increase in utilization.
  - We're encouraged by the progress on exchange enrollment as a result of the Affordable Care Act.
  - During the fourth quarter, we continued to see stability in test volumes on a "same-provider" basis.

- On reimbursement, we will see less government pressure on the Clinical Lab Fee Schedule in 2015 than we've seen in the previous two years.
  - At this time, our industry is focused on effectively implementing the Doc Fix legislation also known as the Protecting Access to Medicare Act of 2014 (or PAMA), which calls for an orderly review of the Clinical Lab Fee Schedule.
  - Our industry trade association, American Clinical Laboratory Association (ACLA), continues to work closely with the Centers for Medicare and Medicaid Services on the rulemaking process.
  - We are hopeful the rulemaking process will be defined in 2015 and will establish an approach to building a representative view of the market.
  - The market view that will be used to update the fee schedule should include participants from the entire market, including large and small independent commercial labs, boutique labs as well as hospitals.
  - The current timetable calls for data to be collected from market participants in 2016, and any revisions to the fee schedule would therefore go in place no sooner than 2017.
  - We'll continue to update you on the progress in the coming year.

- Another important issue facing the industry is the FDA's proposal to extend regulatory oversight to laboratory developed tests.
  - The American Clinical Lab Association is actively opposing the FDA's proposal and has engaged two highly respected experts in constitutional law and administrative procedure, Laurence Tribe from Harvard Law School, and Paul Clement, the former solicitor general of the United States.
  - The FDA proposal is regulatory overreach at its worst, and is bad for patients and the healthcare industry. For that reason the American Medical Association, the American Hospital Association and other leading healthcare providers have urged the FDA to withdraw its proposal.

Now for an update on our Strategy

We continue to improve our ability to execute the company's five-point strategy. As a reminder, our strategy is to:

- Restore growth;
- Drive operational excellence;
- Simplify the organization;
- Refocus on the core diagnostic information services business; and
- Deliver disciplined capital deployment.

Let's start with our highest priority, growth, in reviewing our progress. In 2014, we executed our strategy and restored growth.

- First, we improved our sales effectiveness and how we call on our market. As you have heard me say before, our go-to-market team is better led, better managed, better staffed, better trained, better equipped and better motivated compared to two years ago. We have seen continued improvement in our underlying revenue trends this year.
  - In the fourth quarter, organic revenues grew 60 basis points versus last year.
  - This is the first quarter of organic revenue growth since I joined the company in May, 2012.

- Second, our professional laboratory services business has announced and implemented six new relationships in 2014, which are on track to deliver $40 million in annualized revenues. The most recent contract was finalized in the fourth quarter.

- Third, part of the improving performance is a result of our strategy to focus on esoteric testing through our clinical franchises.
  - We saw sequential improvement in gene-based and esoteric testing for the third consecutive quarter.
  - Some specific esoteric tests that are growing faster include: BRCAvantage breast cancer testing; non-invasive prenatal testing; and hepatitis C.
  - I'm proud of our growing list of strategic partnerships with healthcare leaders that include Memorial Sloan Kettering and University of California at San Francisco.
  - In addition, we continued to see notable growth in the quarter in prescription drug monitoring, wellness and infectious disease franchises.

- We are also making progress on some of our longer term goals… to realize the promise of precision medicine… and the value of our information assets.
  - During Investor Day we spoke about new capabilities we're developing that leverage our connectivity solutions and build on Quest's strong history of healthcare IT innovation.
  - We're developing tools that focus on population health as well as improving provider and patient engagement. I'll say a few words about each.
    - With respect to population health, our Quest analytic tools will help health plans, ACOs, Health Systems and care coordinators identify clinical risk; target and close gaps in care; review performance through our clinical performance scorecard tools; monitor quality metrics; and query patient test information using a new self-service capability that provides on demand access to their patient data.
      - We have seen strong interest in these tools from our customers and you will hear more about them over the course of 2015.
    - In addition to population health tools, we're making progress delivering what we call "interactive insights" to providers and patients.
      - Our interactive insights for providers deliver trending data, interactive features, such as customizable reports; and additional content, such as videos and articles, related to specific conditions and diseases.
      - In the back half of 2014 we launched pilots with providers in women's health and Prescription Drug Monitoring.

    - And then finally, about 1.3 million patients have engaged with our MyQuest patient application, which lets them access and control their own health information.
  - The value of our information assets reaches well beyond our providers and patients.
    - A good example of this is the recent commercial expansion of our relationship with the Centers for Disease Control to improve surveillance of hepatitis C. This demonstrates the value of not just our data but also our diagnostic insights in helping to manage significant public health issues.

  - The CDC relationship builds on the vision we established two years ago that speaks to the impact we have on people's lives: Empowering Better Health with Diagnostics Insights.
  - Our vision was an essential part of becoming more external and customer focused, and over the past two years, we've made tremendous progress bringing that vision to life.
  - We're more than a lab; we're a diagnostic information services company and a trusted partner.

- Finally, our strategy calls for 1-2% growth through acquisitions. During the past year, we closed three acquisitions, Solstas, Steward and Summit.

Next is our strategy for Driving Operational Excellence. The Invigorate program delivered significant cost savings. Our original 2011 savings target was $500 million. We raised it to $600 million at our 2012 Investor Day, and I'm pleased to say we finished 2014 at more than $700 million in run rate savings.

- We are well underway with planning the next phase of Invigorate, which will extend our cost savings to $1.3 billion by the end of 2017. As in the past, we will continue to update you on our progress.

- Beyond cost excellence, our efforts to drive operational excellence have always focused on quality and building a superior customer experience. This is a fundamental principal of quality improvement.
  - We track more than 150 medical quality and service metrics.
  - We continue to make progress broadly on many of these metrics. In particular, we:
    - Delivered Six Sigma quality on our specimen delivery metric;
    - Achieved record availability for our order entry, results and reporting application, called Care360, which puts us at world-class service levels; and
    - We've reduced the time it takes to install EMR interfaces.
  - We are improving service levels while also building a more efficient operation.
  - Our progress on service levels is a testament to the commitment of the 45,000 employees who help us deliver excellent service each and every day. They really are the Quest difference.

- As you can see, we've made strong progress restoring growth and driving operational excellence. A key driver of this has been our third strategy, building a stronger organization to improve our performance. We now have a stronger team and more simplified organization than last year.

- The fourth element of our strategy is to refocus on the core business.
  - We continue to review our portfolio and look at options for non-core assets, and always strive to build value for our shareholders.

- And, finally, we remain focused on the fifth element of our strategy, delivering disciplined capital deployment.

- We returned the majority of our free cash flow to shareholders in 2014.
- We just raised the dividend 15%. This was the fourth increase in three years.
- In the quarter, we paid down debt and repurchased shares, consistent with our commitment earlier this year.

Now**,** Mark will provide an overview on our fourth quarter financial performance and walk you through the details of our 2015 outlook which is based on our strengthening operational performance and an improving business environment

Mark Guinan: Thanks, Steve.

Starting with revenues…

Consolidated revenues of $1.9 billion increased by 7.2% compared to the prior year. On a consolidated basis, organic revenues grew by 60 basis points compared to the prior year.

Our Diagnostic Information Services revenues, which account for over 90% of total revenues, grew by 7.1% compared to the prior year.

Volume, measured by the number of requisitions, increased 8.8% versus the prior year while revenue per requisition was lower than the prior year by 1.5%.

For Diagnostic Information Services, or DIS for short, acquisitions contributed more than 7% to revenues. Acquisitions added nearly 9% to volume and reduced revenue per requisition by approximately 1.5%.

Excluding acquisitions, DIS revenues, volumes and revenue per requisition were all essentially flat for the quarter. I would like to share some additional context on these underlying volume and revenue per requisition metrics:

- First, as you know, earlier this year, we took some actions and trimmed portions of our customer portfolio. Adjusting for these actions, underlying organic volume performance would have improved by approximately 1.5%.

- Second, related to underlying revenue per requisition, the reimbursement pressure in the quarter of less than 50 basis points was offset by favorable test and business mix.

Moving to our Diagnostic Solutions business, which includes risk assessment, clinical trials testing, healthcare IT, and our remaining products businesses, revenues grew by 8.1% compared to the prior year with our Clinical Trials and Risk Assessment businesses driving the growth in the quarter.

Adjusted operating income for the quarter was $283 million, or 15% of revenues, compared to $282 million, or 16.1%, a year ago. The decline as a percentage of revenues can be attributed to lower initial margins from recent acquisitions and the impact of our management incentive compensation.

As Steve mentioned we continued to make very good progress on our Invigorate initiative and delivered more than $200 million in realized savings during 2014, achieving our goal of approximately $700 million in run rate savings as we exit the year.

As we look forward, we have established a goal of $1.3 billion in run rate savings as we exit 2017 - an additional $600 million over the $700 million we exited with in 2014.

For the quarter adjusted EPS of $1.08 was 5% better than a year ago.

The company adjusted out a net benefit of $27 million in the quarter. This net benefit related to a favorable resolution of tax contingencies which was partially offset by charges primarily related to restructuring and integration costs and ongoing efforts to drive operational excellence. This net benefit contributes $0.18 per diluted share to our reported earnings of $1.26 for the fourth quarter. On a reported basis, operating income as a percentage of revenues was 13.7%. Last year's fourth quarter reported operating income from continuing operations was reduced by $12 million related to restructuring and integration costs. These items resulted in a reduction in reported operating income as a percentage of revenues by 0.8% and reported EPS by 6 cents.

Bad debt expense as a percentage of revenues was 3.8%, 20 basis points better than Q3 2014 but 10 basis points higher than a year ago. Our DSOs were 48 days, 2 days higher than last quarter, with the increase partially attributed to mix of business for our employer solutions, wellness and Healthcare IT businesses which tend to have longer payment terms.

In the quarter, as previously mentioned a favorable resolution of tax contingencies along with certain R&D tax credits contributed to our lower tax rate for the year. Looking ahead to 2015, we would expect our tax rate to be similar to the 2013 rate.

Cash from operations was $303 million in the quarter compared to $210 million a year ago. In Q4 2013, cash from operations was negatively impacted by the tax payment related to the gain on the sale of ibrutinib.

Capital expenditures were $89 million in the quarter, compared to $76 million a year ago. The increase in capital spending the quarter reflects investments to support our Invigorate program, the opening of the new laboratory in Marlborough, and continued investments to integrate our recent acquisitions. For the year, capital expenditures were $308 million – in line with our guidance of approximately $300 million.

During the quarter, we continued to return value to shareholders through our dividend and our repurchase of $50 million of our common shares at an average price of $64.44. We also made progress on our debt repayment commitments by reducing our debt by more than $116 million in the quarter.

I would now like to review a few of the considerations underpinning our 2015 guidance:

- Starting with Revenues:
    - We have shared that reimbursement pressure will be moderate between 2015 and 2017 based on our assumptions and we expect our reimbursement experience to be more like what we experienced in 2014 than what we saw in 2013.

  - Our most recent acquisitions, Solstas, Summit & Steward, which contributed more than 7% to DIS revenues in Q4 2014 will anniversary during the first quarter or early second quarter of 2015.
  - At this point, we have not included the benefit of additional acquisitions in our guidance for 2015.

- As you consider expenses:
  - We have established a goal of $600 million in additional run rate savings as we exit 2017 and we are modeling approximately $175 million in realized savings in 2015 related to Invigorate. We are estimating that one-time charges this year related to Invigorate will be in the range of approximately $95 to $115 million. We have provided additional detail on the breakdown of these charges in our 8-K filed earlier this morning. We estimate up to $300 million in investments over the next three years. As we further develop our course of action for the program in 2016 and 2017, we will provide more detail.

- With respect to cycling your models:
  - First, while weather may be a benefit in Q1 compared to a year ago, the snow in the Northeast over the past few days has negatively impacted our business. Therefore, we do not expect to see a complete rebound from last year's harsh winter.
  - Additionally, we expect the benefit of Invigorate and acquisition synergies to build and contribute more to the bottom line as we progress through the year.
  - As a result of these considerations, we expect to see a relatively steady growth rate, quarter by quarter, with only a slightly higher rate in Q1 than what you will see in Q2 through Q4.

- Lastly, as we shared at our Investor Day in November, we are moving guidance to Cash EPS, or adjusted diluted earnings per share, excluding amortization. As described at our Investor Day, we are making this change based on:
  - Feedback and interest from many investors
  - And to provide a comparable reporting presentation to many healthcare companies.
  - Finally, this change in no way impacts the criteria we utilize to analyze potential acquisitions.

- With that back drop, let me frame our thought process on setting our guidance in this year of transition:
  - We started with 2014 full year adjusted diluted earnings per share of $4.10.
  - We built our guidance with a framework that we would deliver approximately a 6% to 10% improvement in performance on our 2014 adjusted diluted earnings per share figure.
  - We then added in the anticipated impact of amortization based on our current amortization schedules. The amortization for 2015 is estimated to be slightly lower than in 2014.
  - Based on that math and our view on the business, we are now sharing a guidance range for adjusted diluted earnings per share, excluding amortization of $4.70 to $4.85.

- Given our strategy to acquire 1-2% in growth each year and the continued need to pay down some debt, you should not anticipate share buybacks beyond the level to meet our majority of free cash flow commitment and the need to prevent any dilution. We also continue to evaluate our portfolio, so should we monetize any significant assets this could change.

- Finally, on cash from operations, please note the forecasted reduction vs. 2014 – despite an anticipated increase in operating income – is driven primarily by two factors. First, given the calendar we have an extra payroll cycle in 2015. This additional payroll cycle is not material to our cash liquidity. The second driver is the payout of accrued management compensation which was depressed in 2014.

Based on these considerations, we expect full year 2015 results from continuing operations, before special items, as follows:

- Revenues to increase between 2% to 3% compared to 2014;
- Adjusted diluted earnings per share, excluding amortization expense to be between \$4.70 and \$4.85;
- Cash provided by operations to approximate \$850 million. And capital expenditures to approximate \$300 million.

Now, let me turn it back to Steve.

Steve Rusckowski: Thanks, Mark.

To summarize:

- **We delivered solid top and bottom line growth in the fourth quarter.**
- **In doing so, we reported organic revenue growth as we continue to build momentum.**
- **We made good progress executing our strategy.**
- **As a result, we met our commitments for 2014, raised our dividend once again, and have provided guidance for 2015 that shows continued improvement.**
- **Thanks for your support.**