Q3 2016
CONFERENCE CALL SCRIPT
Thursday, October 20, 2016, 8:30 am ET
773-681-5898, PASSWORD: 3214469

Conference operator: Welcome to the Quest Diagnostics Third Quarter 2016 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 Shawn Bevec, Executive Director of Investor Relations for Quest Diagnostics. Go ahead, please.

Shawn Bevec: 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. For this call, references to adjusted EPS refer to adjusted diluted EPS excluding amortization. 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' 2015 Annual Report on Form 10-K, quarterly reports on Form 10-Q and Current Reports on Form 8-K.

The text of our prepared remarks and a PowerPoint presentation will be available later today in the Investor Relations page of our website.

Now, here is Steve Rusckowski.

Steve Rusckowski: Thanks, Shawn, and thanks, everyone, for joining us today.

This morning, I'll provide you with highlights of the quarter and review progress on our strategy. Then Mark will provide more detail on the results and take you through our updated guidance.

During the third quarter:

- Revenues were up on a reported basis and grew 2.1% on an equivalent basis;
- Reported EPS decreased 43% primarily due to the gain from the 2015 contribution to the Q Squared Solutions joint venture. On an adjusted basis, EPS grew 7%;
- Cash from operations were $301 million, up 42%

Now let me discuss highlights of progress we are making in several areas of our five-point strategy, which, as you know, is to:

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

Let's start with growth.

We continue to make progress with our expanded hospital system relationships.

In Professional Laboratory Services, HCA began to contribute to growth in the third quarter. As we announced earlier this year, we are managing in-patient laboratory operations for six Denver-area hospitals in the HealthONE system of HCA Healthcare. Revenues from this engagement will continue to increase through the end of the year.

Our professional lab services agreement with RWJBarnabas Health in New Jersey and Clinical Laboratory Partners, the outreach lab business we acquired from Hartford HealthCare in Connecticut, both continue to perform well and contribute to revenue growth.

Beyond our hospital system relationships, we also continued to deliver solid growth in prescription drug monitoring and infectious disease testing, including Zika.

- In prescription drug monitoring we remain an industry leader, with strong growth in the quarter. Providers and payers appreciate our unique ability to help manage the epidemic of prescription drug abuse with appropriate test utilization.
- In infectious disease, we continue to see solid growth in fourth generation HIV testing as well as Hepatitis C testing for screening and genotyping to help doctors determine the type, dose or duration of treatment.
- Turning to Zika, we complemented our proprietary PCR test with a new antibody test licensed from the CDC. Quest Diagnostics is proud to be among a group of select national reference laboratories selected by CDC to aid the response to the Zika emergency in the United States.

Looking forward, we are excited about our new agreement with Ancestry. Quest will become Ancestry’s first CLIA approved lab partner to provide DNA testing, enabling AncestryDNA subscribers to build their family tree based on ethnic origins. Over time, we intend to explore additional opportunities with Ancestry to guide people on building and understanding their "family health tree."

We are very excited about the recent launch of *IBM Watson Genomics from Quest Diagnostics*, a new service that helps advance precision medicine by combining cognitive computing with genomic tumor sequencing.

The service helps oncologists match patients with cancer therapies and clinical trials based on the tumor's unique DNA.

Quest's expertise in genomics and cancer, as well as our broad market penetration to half the country's physicians and hospitals means Watson-powered tumor sequencing is accessible for the first time to community oncologists, who provide 70 percent of the nation's cancer care.

Memorial Sloan Kettering and Broad Institute will contribute their data and research expertise to further augment the offering.

The next element of our strategy I will highlight is driving operational excellence.

Our collaboration with Optum will help Quest reduce the cost and complexity of our billing processes, and also increase transparency of health care costs for patients, physicians and employers.

Employee engagement in our Optum alliance has been positive and the integration is on track. Quest employees will transition to the Optum team in mid-November. We expect to begin realizing savings from this relationship next year.
We view this agreement with Optum as the start of a long-term relationship, and it builds on our long-standing relationship with Optum's parent, UnitedHealth Group. For decades, Quest has served UnitedHealthcare plan participants to help them take action to improve their health based on insights from diagnostic testing and information services.

In the third quarter we also opened Quest Patient Services Centers (PSCs) in 12 Safeway supermarkets in five states. In just the first few months, patients are finding it easier to access testing in a more convenient location, and we've seen volumes increase in these retail settings. We remain excited about expanding patient access through retail partnerships.

We continued to execute on the last element of our strategy, which is to deliver disciplined capital deployment. We completed our $250 million Accelerated Share Repurchase program announced in May, using the proceeds of the sale of the Focus Diagnostics business. Through this ASR we repurchased approximately 3.1 million shares. Additionally, we bought back another $50 million of company stock, bringing the total repurchases in 2016 to $440 million through the end of the third quarter.

We look forward to sharing more detail on our market views and strategic outlook at our third Investor Day at The Intercontinental New York Barclay Hotel in Midtown on November 11th. Registration information is available on our Investor Relations webpage.

Now, Mark will provide an overview on our third quarter financial performance and provide you with an update on our 2016 outlook.

Mark Guinan: Thanks, Steve.

Starting with revenues…

Consolidated revenues of $1.89 billion were up 0.3% versus the prior year on a reported basis. Equivalent revenues grew 2.1% for the company.

Revenues for Diagnostic Information Services, or DIS for short, grew by 2.1% compared to the prior year. Of this growth, approximately 1% was organic.

Volume, measured by the number of requisitions, increased 2% versus the prior year. Approximately half came from organic growth including our Professional Lab Services, or PLS, engagements, and the other half from recent acquisitions.

Revenue per requisition in the third quarter was flat versus a year ago. As a reminder, revenue per req is not a proxy for price. It includes a number of variables such as: unit price variation; business mix; test mix; and tests per req. Unit price headwinds moderated in the third quarter, down roughly 50 basis points compared to the 100 basis point headwinds we observed in the first half.

Consistent with previous quarters, our PLS engagements such as RWJBarnabas Health and HCA carry lower revenue per requisition due to the nature of the work we are performing and will lower the revenue per req calculation. In the third quarter, the impact of our PLS engagements was slightly larger than the 120 basis points we highlighted in the second quarter, which is representative of the strong growth we are seeing in this business.

With HCA coming on line in the third quarter and ramping up through the end of the year, we expect PLS to continue to grow at a faster rate than the balance of our business in Q4.

After considering the impacts of unit price and PLS, other mix elements, including test and payer mix, contributed nearly 2% to revenue per req in the quarter.

Reported operating income for the quarter was $322 million, or 17.1% of revenues, compared to $631 million, or 33.6% of revenues, a year ago. Our reported third quarter 2015 results included a $334 million pre-tax gain on the contribution to our Q Squared joint venture with Quintiles. On an adjusted basis, operating income was $320 million, or 17% of revenues, compared to $325 million, or 17.3% of revenues last year. The impact of our former Focus Diagnostics and Celera products businesses in the third quarter of 2015 benefitted adjusted operating income by approximately $16 million or 50 basis points. Excluding this impact, margins would have grown by 20 basis points year over year.

Reported EPS was $1.34 in the quarter compared to $2.35 a year ago. The year-over-year decline was driven primarily by the net gain on our Q Squared contribution mentioned previously. Adjusted EPS was $1.37, up from $1.28 last year.

The company recorded special items with an after-tax benefit totaling $10 million in the quarter, representing an escrow recovery associated with an acquisition which was partially offset by restructuring and integration charges. The net impact of these items benefited our reported EPS by 7 cents.

Bad debt expense as a percentage of revenues was 4.0%, 20 basis points better than the previous quarter and 10 basis points higher than 2015. As a reminder, bad debt expense typically improves modestly throughout the year as patients hit their health insurance deductibles. Note that the year-over-year compare is negatively impacted by the fact that our products businesses had a lower associated bad debt rate. When taking this into consideration, our bad debt rate was flat year over year.

A quick comment on our new billing relationship with Optum. To reiterate, expense savings from this relationship will not begin until 2017. We expect modest savings on our billing support costs during each year of the 10-year agreement and Optum will work with us to help lower our bad debt rate as well as reduce our denials over time.

Income tax expense in the quarter benefited from the adoption of the new accounting standard related to stock based compensation. The impact amounted to an EPS benefit of roughly 2 cents in Q3. The new standard also results in a change in weighted shares outstanding by increasing the effect of dilutive securities, which slightly offsets the EPS benefit.

Our DSOs were 46 days, 2 days higher than last year but 1 day better than the prior quarter. The year over year increase is primarily attributable to higher levels of patient responsibility.

Through the first nine months of 2016, cash provided by operations was $765 million versus $549 million last year.
Capital expenditures were $165 million through the third quarter, compared to $169 million a year ago.

Before moving to guidance, I'd like to highlight that operations in our Southeast region were impacted by Hurricane Matthew earlier this month. Our updated guidance reflects the impact we currently know.

Additionally, I want to provide some color on a few notable items which will impact our full year operating cash flows.

- The first relates to after tax cash charges for the full year 2016 of $29 million from the retirement of debt.
- Second, we will incur a full year cash tax outlay of $91 million associated with the Focus divestiture that will be recorded in our operating cash flow while the associated $275 million from the sale is reported in our investing cash flow. We paid $68 million of this liability in Q3 with the remainder to be paid in the fourth quarter.
- Third, in Q3 we realized $54 million of proceeds from the termination of interest rate swap agreements.
- In aggregate these three items are adversely impacting our full year operating cash flow by a net $66 million.

Now, turning to guidance. Based on our year to date results, we are narrowing our 2016 outlook as follows:

- Revenues to be approximately $7.51 billion, an increase of about 0.5% versus the prior year on a reported basis, and an increase of about 2.5% on an equivalent basis. This compares to previous revenue guidance of between $7.47 billion and $7.54 billion.
- Reported diluted EPS to be between $4.47 and $4.52 and adjusted EPS to be between $5.07 and $5.12. This compares to previous EPS guidance of $4.18 and $4.33 on a reported basis and $5.02 and $5.17 on an adjusted basis.
- Cash provided by operations to be approximately $1 billion which compares to previous guidance of approximately $880 million; and finally
- And finally, capital expenditures to be approximately $250 million, compared to between $250 million and $300 million previously.

Now, let me turn it back to Steve.

Steve Rusckowski: Thanks, Mark.

To summarize:

- **We continued our success in 2016 with another good performance in the third quarter.**
- **We continued to generate strong cash from operations.**
- **And we remain on track to meet our commitments for the remainder of the year.**

STEVE: Thanks again for joining our call today.

- We are making good progress executing our strategy.
- We look forward to seeing many of you at our investor day in New York City on November 11th.