Q2 2018
CONFERENCE CALL SCRIPT
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Shawn Bevec: Thank you and good morning. I am here with Steve Rusckowski, our Chairman, President and Chief Executive Officer, and Mark Guinan, our Chief Financial Officer. During this call, we may make forward-looking statements and will 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 our most recent Annual Report on Form 10-K and subsequently filed quarterly reports on Form 10-Q and Current Reports on Form 8-K. For this call, references to reported EPS refer to reported diluted EPS and references to adjusted EPS refer to adjusted diluted EPS excluding amortization expense. As a reminder, adjusted diluted EPS excludes excess tax benefits associated with stock based compensation. Additionally, net revenues and selling, general and administrative expenses have been restated for the basis of prior year comparisons to reflect the impact of the new revenue recognition standard that became effective January first, 2018 and was adopted on a retrospective basis. Under the new rules, the company now reports uncollectible balances associated with patient responsibility as a reduction in net revenues when historically these amounts were classified as bad debt expense within selling, general and administrative expenses.

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 2-point strategy which continues to drive results. Then Mark will provide more detail on second quarter performance.

The highlight of the quarter was establishing our long-term strategic partnership with UnitedHealthcare. I will share more on this relationship in a few moments.

We delivered strong earnings growth in the quarter, driven by revenue growth and the benefits of tax reform.

Here are some key highlights from the quarter:

- Revenues were up 3 percent despite some headwinds in the marketplace;
- Reported EPS was up more than 14 percent from 2017. Adjusted EPS grew more than 20 percent.

Before I describe the progress we have made, I'd like to provide an update on PAMA.

We continue to support efforts by our trade association to implement a market-based laboratory reimbursement schedule. On the legal front, ACLA has sued CMS, and both sides have submitted their briefs to the court, and we are awaiting the judge to rule on the briefs or set a date to hear our oral arguments. In the meantime we continue our outreach efforts to find a legislative solution.

Earlier this month we were pleased to learn that CMS is asking stakeholders to provide comments on how to improve future data collection and reporting periods under PAMA. This is a proper step, since as we've said all along, PAMA's current reporting requirements undermine any effort to establish a sustainable, "market-based" payment model and deliver the care that patients need.

But the key will be what CMS does with the requested comments. And moreover, the need for change is now.

Changing data collection for future reporting periods does not undo the harm caused by the flawed data collection process that was used in connection with establishing the current rates.

Turning to the second quarter, we delivered on all five elements of our strategy to accelerate growth.

The <u>first</u> element of our growth strategy is to grow 1-2% through strategically aligned, accretive acquisitions.

We completed our previously announced acquisition of the outreach laboratory services business of Cape Cod Healthcare in Massachusetts, the leading provider of healthcare services for residents and visitors of Cape Cod.

Our integration efforts from acquisitions completed in 2017 continue to drive revenue growth, and our M&A pipeline remains strong.

As we've continued our conversations with hospital system CEOs from around the country, it's clear from those discussions that there is a growing awareness of PAMA and the impact it has on their outreach laboratory business. CEOs are increasingly interested in talking more about how we can help them execute their lab strategy. As you'll recall, this can involve improving their hospital lab operations, working with us on reference testing, and potentially selling their outreach lab business to us.

In addition to PAMA, hospital CEOs are also seeing the trend in health plans like Aetna and UnitedHealthcare partnering with high value providers like Quest to reduce their laboratory spend and bring down the cost of care.

Under the <u>second</u> element of our growth strategy, we continued to expand relationships with health plans and hospital health systems.

In May we announced our long-term strategic partnership with UnitedHealthcare. Beginning January 1, 2019, Quest will be participating as a national provider of laboratory services for all UnitedHealthcare plan participants.

We are excited about this partnership, as it includes a broad range of value-based programs, rewarding high quality, easily accessible laboratory services at the best value and real-time data sharing to drive more personalized care.

We are positioning ourselves to be well-prepared to provide UnitedHealthcare's members with a first-class customer experience.

Our commercial team has also been proactively reaching out to physician customers to let them know we will be in network with UnitedHealthcare on January first.

Additionally, we've been fielding inquiries from customers who are committing to send us an increasing share of their UnitedHealthcare patient specimens in 2019.

We are delivering on the third element of our growth strategy, which is to offer the broadest access to diagnostic innovation.

We continue to see strong growth in Prescription Drug Monitoring, Quantiferon tuberculosis testing, and Non-invasive pre-natal screening.

In the second quarter we experienced three dynamics which impacted the marketplace:

- First, the growth we saw in the Prescription Drug Monitoring market, although strong, was less than expected because of policy changes imposed by some payers to limit testing. We're engaging directly with these payers to show the medical necessity of this testing and so far have had success getting at least one payer to reverse its policy change.
- Second, in the Hep C market, we saw a faster than expected decline in genotyping and resistance testing. This was largely due to the rapid acceptance of AbbVie's new Hepatitis C therapy which works across multiple genes and does not require the same level of testing as previous therapies. We still see a tremendous opportunity in Hep C screening. Our screening business continues to grow, and we estimate that two-thirds of more than 70 million baby boomers still have yet to be screened.
- Finally, our Vitamin D testing slowed in the quarter due to increased reimbursement denials. We are working with payers and providers to ensure that appropriate testing is being performed for patients who need it.

We continue to make strong progress executing the <u>fourth</u> element of our growth strategy, which is to be the provider of choice for consumers.

- Our Walmart locations continue to see increased traffic and be well-received by our customers. We are now operating inside 12 Walmart locations in Florida and Texas.

- We will have more to say about our consumer strategies, including MyQuest, our digital experience and consumer offerings at our Investor Day in November.

The fifth element of our growth strategy is to support population health with data analytics and extended care services.

I'm excited about last month's launch of Quest Clinical Trials Connect, a new patient recruitment service to help pharma companies and CROs speed the development of new therapies. We have already engaged several pharma, biotech and CRO companies with this solution.

In the area of population health, in June we released a study on employer wellness and screening at the American Diabetes Association Scientific Session showing a strong association between wellness participation and health outcomes. The study showed that a third of at-risk employees identified by screening who then participated in a behavioral health program to reduce diabetes risk reduced glucose and hemoglobin A1c to normal levels. Also, more than one-quarter of participants lost five percent or more of body weight, reducing the risk of many obesity-related conditions.

This news is catching the attention of both employers and health plans as they proactively look for opportunities to bend their health care cost curve. We are strengthening an already solid position in this market.

The second element of our two-point strategy is to drive operational excellence.

We are continuing to drive efficiency and effectiveness within Quest to cover the cost of wage inflation and reimbursement pressure. Our efforts to digitize our processes are improving the customer experience.

Here are two simple, real examples of improvement opportunities in front of us:

- First, as we've shared previously, processing a paper requisition takes approximately four minutes. E-enablement allows us to improve both efficiency and quality. We are making progress in our efforts to get clients to submit electronic requisitions. Today, more than 70 percent of the requisitions we receive are sent electronically, up from approximately 60 percent in 2016.

- Second, we have developed a client friendly application which allows physicians and their staffs to order specimen pickups. Since the launch earlier this year, over five thousand clients have converted to online pickup through our Quanum HCP portal, and we're adding 200 clients each week. Each day, more than 13 percent of routine, on-demand pickup requests are received electronically through our new application, and we expect that rapid adoption to continue. This has translated into fewer calls to our call center and significantly fewer occurrences of a courier arriving to find an empty lockbox.

Now, let me turn it over to Mark, who will take you through our financial performance.

Mark Guinan: **Thanks, Steve.**

Consolidated revenues of $1.92 billion were up 3% versus the prior year. As a reminder we now report uncollectible balances associated with patient responsibility as a reduction of net revenues instead of bad debt due to a change in revenue recognition accounting.

Revenues for Diagnostic Information Services, or DIS for short, grew 3.3% compared to the prior year driven largely by acquisitions.

Volume, measured by the number of requisitions, increased 2.5% versus the prior year with acquisitions contributing approximately 200 basis points. Volume was softer than expected due in large part to the specific market dynamics highlighted by Steve earlier.

Revenue per requisition in the second quarter grew by 20 basis points versus the prior year. 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.

During the second quarter, unit price headwinds remained consistent with those observed in the first quarter with a headwind of approximately 50 basis points from PAMA and less than 100 basis points from all other factors.

Absent any changes to PAMA, Medicare reimbursement pressure will increase in 2019 as we have indicated previously.

Beyond unit price, other mix elements remained strong in the quarter and more than offset reimbursement headwinds.

Reported operating income for the quarter was $305 million, or 15.9% of revenues, compared to $319 million, or 17.1% of revenues, a year ago.

On an adjusted basis, operating income was $340 million, or 17.7% of revenues, compared to $343 million, or 18.4% of revenues last year. The decline in operating margin was due to several factors including:

- Investments using tax reform savings had a 60 basis point adverse impact on operating margin; and
- Some of our larger acquisitions, which are in early stages of integration and therefore not yet delivering full margin contribution; and
- PAMA.

Reported EPS was $1.57 in the quarter compared to $1.37 a year ago. Adjusted EPS was $1.75, up more than 20% from $1.45 last year.

During the quarter, uncollectible balances associated with patient responsibility, which we now call patient price concessions were flat year over year. Cash provided by operations year to date was $503 million versus $490 million last year.

Capital expenditures year to date were $151 million, compared to $107 million a year ago, which is in line with the higher capex spend planned for 2018.

Now, turning to guidance. We are narrowing our outlook for 2018 as follows:

- Revenues now expected to be between $7.70 billion and $7.74 billion, an increase of 4 to 4.5% versus the prior year.

- Reported diluted EPS to be between $5.50 and $5.64 and adjusted EPS, to be between $6.53 and $6.67.
- Cash provided by operations continues to be approximately $1.3 billion; and
- Capital expenditures continue to be between $350 million and $400 million.

In addition, keep in mind that the investments in the business we are making related to tax reform savings will continue to ramp up as we progress throughout the remainder of 2018. Some of these investments are related to preparing to be a national in-network provider for UnitedHealthcare.

Our narrowed revenue guidance reflects our performance through the first half.

As you think about the second half of the year, consider the following:

First, the actions we are taking in the areas of PDM and Vitamin D testing;

Second, as Steve mentioned, health systems are talking to us more about how we can help them execute their lab strategy. We have a few professional lab services agreements we expect to close in the second half.

Taken together, we expect the benefit of these items will build as we progress through the remainder of the year.

Finally, last year's severe hurricane impacts should make for an easier comparison this year. The majority of the impact was in the third quarter, with some carryover in the fourth quarter as well.

To sum it up, we expect growth to accelerate through the second half, and remain confident in our ability to achieve our 2018 outlook.

I will now turn it back to Steve.

Steve Rusckowski: Thanks, Mark.

To summarize:

- **We grew revenues and delivered strong earnings in the second quarter;**
- **We're excited to build on our strategic relationship with UnitedHealth Group; and**
- **We remain focused on executing our two-point strategy and are confident we will meet our commitments for the remainder of 2018.**

Now we'd be happy to take your questions.

STEVE: Thanks again for joining our call today. We appreciate your continued support.

- Have a good day, everybody.