

DGX – Q3 2018
CONFERENCE CALL SCRIPT
Tuesday, October 23, 2018, 8:30 am ET

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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 which we will refer to as patient concessions, 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. Then Mark will provide more detail on third quarter performance and give you an update on our outlook for 2018.

We grew revenues and continued to deliver strong earnings growth in the quarter:

- Revenues were up nearly 2 percent despite the effect of the industry headwinds we called out last quarter;
- Reported EPS was up more than 32 percent from 2017. Adjusted EPS grew more than 25 percent.

As you saw, we have revised our full year revenue guidance to reflect our lower than expected revenue performance this year, which was affected primarily by two factors.

First, as we detailed in the second quarter, we faced headwinds in the areas of Prescription Drug Monitoring, Hepatitis C, and Vitamin D testing. While we made some progress, these testing areas continued to impact revenue growth in the third quarter.

Second, in the third quarter we also saw a rise in patient concessions, which Mark will touch on later.

Before getting into the details of progress we have made in the quarter, I'd like to provide context on some market trends, starting with an update on PAMA.

Last month a US District Court judge dismissed on narrow procedural grounds our trade association's lawsuit over the implementation of new Medicare pricing for lab tests under PAMA.

The Court's opinion, however, acknowledges that ACLA's 'arguments on the merits raise important questions,' about HHS's actions.

This is, of course, disappointing for our industry; and it is potentially harmful to Medicare beneficiaries.

Last week ACLA appealed the District Court's decision, demanding a hearing on the merits. At the same time, the industry continues to pursue a legislative fix. Additionally, CMS and our industry continues to work together on addressing the current PAMA issues.

As we sit here today, PAMA is having an impact on Quest and the rest of the lab market. Increasingly, smaller independent labs and hospital outreach labs are struggling financially due to lower Medicare reimbursement – not only directly due to PAMA but also under contracts with pricing indexed to Medicare. Some have begun to exit the business, citing PAMA as a factor. We are continuing to plan and manage our business as if PAMA is here to stay.

At the same time, there has been increasing scrutiny of the wide variation in health care pricing in the popular press.

Consumers and employers, who pay for most of healthcare, are becoming more price sensitive. Last month the Wall Street Journal reported that health plans that exclude costly providers can be much less expensive for consumers and employers. Quest offers a great customer experience, and coupled with our scale and efficiency, it makes us an exceptional value in the market compared with hospital outreach labs, which often charge two-to-five times more than Quest.

In short, there are three reasons we believe the market will continue to consolidate and therefore afford us an opportunity to accelerate growth:

- First, reduced reimbursement through the Medicare Clinical Lab Fee Schedule is beginning to have an impact on the laboratory industry;
- Second, health plans are embarking on a new strategy, looking to national labs to help drive efficiency in lab spending; and
- Finally, consumers and their employers are more attuned to variation in healthcare pricing.

Turning to the third quarter, I'll review our execution against the five elements of our strategy to accelerate growth.

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

We announced three acquisitions in the third quarter which strengthen our capabilities in several key areas:

- First, our acquisition of PhenoPath, which has a strong record of innovation, provides several capabilities that complement and extend our own, particularly in pathology and molecular oncology. It also expands our presence in the Pacific Northwest.

- Our acquisition of the U.S. laboratory services business of Oxford Immunotec will extend our capabilities in infectious disease diagnostics. It will allow us to bring greater choice to physicians who seek innovative blood-based Tuberculosis and tick borne disease testing.
- Finally, our acquisition of ReproSource expands our expertise in reproductive diagnostics.

Since the third quarter closed we have also announced the acquisition of Hurley Medical Center's outreach lab operation in Flint, Michigan, with the seller indicating reimbursement pressure as a factor in deciding to exit the business.

Additionally, we acquired the assets of Provant Health to strengthen our employer wellness business.

The acquisitions, which were announced and will close in 2018, already position us to be within our 1-2% revenue growth target for next year. And, as I indicated, PAMA should further contribute to our strong M&A pipeline.

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

We continue our preparations to take advantage of the opportunity to offer a first-class customer experience for UnitedHealthcare providers and their members when we become an in-network lab provider on January first.

Our commercial team has also been proactively reaching out to educate physician customers about their ability to use Quest for their UnitedHealthcare members.

The revenue opportunity presented by the United contract will ramp over time. We expect some portion of this new work to transition quickly. However, the larger opportunity to help UnitedHealthcare drive lower lab spend is expected to be realized over the next several years.

The third element of our growth strategy is to offer the broadest access to diagnostic innovation. Our announced acquisitions in the quarter mentioned earlier will enhance our capabilities in advanced diagnostics, especially in the areas of Women's Health and Infectious Disease.

We continue to see strong growth in Prescription Drug Monitoring and Quantiferon tuberculosis testing. Additionally, this quarter we saw solid growth in Cardio IQ as well as testing for sexually transmitted diseases.

On our Second Quarter call, we highlighted several market headwinds that impacted growth in Prescription Drug Monitoring, Hepatitis C and Vitamin D testing.

We saw modest improvement in the third quarter. For example, PDM denials have steadily improved each quarter this year. We've also started to lap the Hep C headwinds we began to experience roughly a year ago.

In aggregate, the issues we have mentioned related to these three tests contributed approximately 100 basis points of headwinds this year against our original revenue expectations.

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

- Quest Walmart locations continue to see increased traffic and generate great feedback from our customers. In fact, for locations open more than 6 months we've seen an uptick in volumes compared to the patient service centers they replaced. We are currently operating inside 21 Walmart stores in

Florida, Texas and now Illinois. Combined with our partnership with Safeway, we expect to have well over 200 patient service centers in retail store locations by the end of 2018.

- Customers continue to embrace our digital experience. We now have more than 6 million users on our MyQuest app that lets them view and analyze test results, schedule appointments, see patient service center wait times, and pay bills.

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

We're seeing continued interest in Quest Clinical Trials Connect, which we launched in June. This is a new patient recruitment service to help pharma companies and CROs increase the speed of commercializing new therapies. We're working with several pharma, biotech and CRO companies with this solution.

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

At the end of September, we launched a new appointment scheduling system for our patients. This new system uses best-in-class technologies to help patients schedule appointments at a convenient location. In the second week of deployment alone, we saw appointment-related calls into our National Customer Service center drop by more than 10%.

Our Online Specimen Pickup option has been a hit with our physician customers with nearly 20% of routine pick-up requests now handled electronically versus making a call. Physicians have given us positive feedback on the ease, efficiency and simplicity compared to waiting on the phone and writing down confirmation numbers.

Finally, our Invigorate program remains strong and we are on track to over-deliver on expected savings for 2018.

Overall, we continue to make excellent progress on our operational excellence strategy and our leaders will be sharing more insights, successes and plans with those that attend our Investor Day which will be held November 29th in New York.

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

Mark Guinan: Thanks, Steve.

Consolidated revenues of \$1.89 billion were up 1.8% versus the prior year. As a reminder, we now report patient concessions as a reduction of netrevenues instead of bad debt due to a required change in revenue recognition accounting.

Revenues for Diagnostic Information Services, or DIS for short, grew 1.9% compared to the prior year, driven by acquisitions and an easier compare due to the hurricane effect last year.

Volume, measured by the number of requisitions, increased 2% versus the prior year. Excluding acquisitions, volumes grew approximately 70 basis points.

Revenue per requisition in the third quarter declined by 80 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 third quarter, unit price headwinds remained consistent with our expectations for the full year with a headwind of approximately 50 basis points from PAMA and approximately 100 basis points from all other factors.

As we've shared previously, Medicare reimbursement pressure will increase in 2019 due to PAMA.

Other mix elements remained positive in the quarter and partially offset the impact of reimbursement headwinds as well as growth in our professional laboratory services business.

Reported operating income for the quarter was \$304 million, or 16.1% of revenues, compared to \$298 million, or 16.1% of revenues last year.

On an adjusted basis, operating income was \$311 million, or 16.5% of revenues, compared to \$325 million, or 17.5% of revenues last year. The decline in adjusted operating margin was due to several factors including:

- Investments related to tax reform savings which had a 60 basis point adverse impact on operating margin;
- Integration efforts of acquisitions, which take time to deliver a full margin contribution; and
- The impact of PAMA.

Reported EPS was \$1.53 in the quarter compared to \$1.15 a year ago. Adjusted EPS was \$1.68, up approximately 25% from \$1.35 last year.

During the quarter, patient concessions, previously recognized as part of bad debt, were up as a percentage of revenue year over year. We continue to see an increase in patient revenues as a percentage of total revenue due to the ongoing trend of rising patient deductibles and an uptick in uninsured patients.

Cash provided by operations year to date was \$905 million versus \$852 million last year.

Capital expenditures year to date were \$232 million, compared to \$170 million a year ago, which is in line with the higher capex spend planned for 2018.

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

- Revenues now expected to be approximately \$7.62 billion, an increase of approximately 3% versus the prior year.
- Reported EPS to be between \$5.57 and \$5.64 and adjusted EPS, to be between \$6.53 and \$6.60.
- Cash provided by operations continues to be approximately \$1.3 billion; and
- Capital expenditures continue to be between \$350 and \$400 million.

Our updated guidance reflects the industry headwinds we've experienced versus our expectations in 2018. While we aren't prepared to share 2019 guidance, there are some elements I'd like you to keep in mind.

- First, we have a significant opportunity to grow with our new

UnitedHealthcare contract. However, moving in network comes with lower reimbursement versus the out of network services we provide to UHC patients today.

- Second, as Steve mentioned earlier, we are already on track to deliver 1-2 percent revenue growth from M&A next year.
- Third, as you are already aware, the impact from PAMA is expected to increase from a headwind of approximately 50 basis points this year to more than 100 basis points in 2019;

- And finally, we expect approximately 150 basis points of reimbursement pressure beyond PAMA from our third party payers, which includes the impact of becoming an in-network provider for United and other health plan contract changes; as well as hospitals and physicians that we bill directly.

After considering these headwinds and tailwinds, we are well- positioned to grow revenue and earnings in 2019. We look forward to sharing more detail with you at Investor Day.

I will now turn it back to Steve.

Steve Rusckowski: Thanks, Mark.

To summarize:

- **Revenues grew and we delivered strong earnings in the third quarter;**
- **We're excited about our M&A activity in the quarter, and are well-positioned for top and bottom-line growth in 2019;**

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.