Q4 Full Year 2017
CONFERENCE CALL SCRIPT
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Conference operator: Welcome to the Quest Diagnostics Fourth Quarter and Full Year 2017 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 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 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. 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. 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. This quarter we have included a 2018 adjusted EPS bridge on the Investor Relations page of our website. The text of our prepared remarks will be available on the site later today.

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 fourth quarter, and full year 2017, and review progress on our strategy. Then Mark will provide more detail on the results and take you through our 2018 guidance.

We finished the year on a high note by delivering a strong fourth quarter:

- Revenues grew 4 percent;
- Reported EPS grew 67 percent and adjusted EPS grew nearly 7 percent.

For the full year 2017:

- Revenues were up 2.6% on a reported basis and up 2.9% on an equivalent basis versus 2016.
- EPS was up 22 percent on a reported basis, and more than 10 percent on an adjusted basis.
- Cash provided by operations was up nearly 10 percent from 2016.

2017 was a good year, and I'm pleased to announce we are increasing our quarterly dividend 11%. This is the seventh increase since 2011.

Before I describe the progress we have made, I'd like to talk about two dynamics impacting our industry – PAMA and tax reform.

PAMA represents a significant headwind.

In November we said that we expect the impact of the final rates under PAMA to be approximately 4% of our revenues from the clinical lab fee schedule in 2018, and approximately 10% in both 2019 and 2020.

As you know, in December we fully supported ACLA's lawsuit charging that the Centers for Medicare & Medicaid Services failed to follow a congressional directive to implement a market-based laboratory payment system, and we believe we could have a decision from the judge by mid-year. In the meantime, our trade association will continue to work with Congress to secure a legislative solution.

Turning to tax reform, Quest is a significant beneficiary of lower corporate tax rates which will enable us to grow earnings per share and invest in our business and our people.
We will realize approximately $180 million in tax savings on an adjusted basis in 2018. With those tax savings we are reinvesting roughly $75 million before tax back into the business, and our people.
Some of these initiatives include:

- Advanced diagnostics innovation through new tests and high-touch concierge services;
- Investments to deliver a consistently excellent consumer experience both online through our MyQuest patient app and at all of our patient service centers;

And finally, we will pay a bonus of up to $500 to about 40,000 employees as a way of saying thanks for playing a vital role in our success. This bonus will be based on the company's performance in accelerating growth in 2018.

Turning to the progress we've made in the fourth quarter, we delivered on all five elements of our strategy to accelerate growth.

The first element of our growth strategy is to grow 1-2% per year through strategically aligned, accretive acquisitions, which we achieved for the fifth consecutive year.

We had another very productive quarter for M&A. We completed our previously announced acquisitions of Cleveland HeartLab, which builds on our position in advanced diagnostics, and Shiel Medical Laboratory, which will further strengthen our position in the New York metro market.

Our M&A pipeline remains very strong, and our strategy is delivering growth, as evidenced by our recently announced acquisition of Mobile Medical Examination Service, or Med Exam, a leading national provider of home-based health risk assessments and related services.

Our seven announced acquisitions in 2017 will enable us to exceed our long term M&A objective of 1 to 2 percent top line growth for 2018. And, of course, any earnings accretion realized from these acquisitions in 2018 will help offset the impact of new Medicare rates.

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

Our professional lab services revenues grew by double digits in 2017 and delivered healthy operating margin, as more hospitals benefited from the standardization, scale and innovation that we bring to these relationships. While the new Medicare rates are a headwind for us, we also believe the rates will be a catalyst for consolidation later in 2018 and beyond as hospital systems face increasing pressure from lower Medicare rates. We've had a growing number of conversations with hospital C-Suites that indicate their increased sense of urgency about rethinking their lab strategy.

We took a number of actions to deliver on the third element of our growth strategy, which is to offer the broadest access to diagnostic innovation.

In women's health, we continue to be excited about the progress we are making in noninvasive prenatal screening. Our QNatal test enjoyed strong double digit growth in 2017.

Other contributors to growth in 2017 were Prescription Drug Monitoring, with growth in excess of 20 percent, Quantiferon tuberculosis testing, and Hepatitis C screening, which posted double digit growth in 2017.

We have also established new Advanced Diagnostics centers of excellence for CardioMetabolic testing and Precision Oncology in conjunction with our acquisitions of Cleveland HeartLab and MedFusion.

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

- We opened 6 locations in Walmart stores in 2017, five in Florida and one in Texas.
- The early feedback from our patient satisfaction surveys is extremely positive. Our customers appreciate the convenience of being able to get their testing done where they shop, the ease of check-in provided by e-enablement, and the professionalism of our phlebotomists.
- There is more to come in 2018, as our collaboration with Walmart expands to include basic healthcare services. We will keep you posted on our progress.
- Our relationship with Safeway, which is now in its second year, continues to expand, as we are now operating in 184 stores in 12 states. We have received similar positive feedback from both our customers and employees on their experience in these locations.
- We're also empowering healthcare consumers with our MyQuest mobile application, which is now delivering lab results into the hands of nearly five million users, an increase of more than 1.3 million users in 2017.

The fifth element of our growth strategy is to support population health with data analytics and extended care services. We are building a solid data analytics pipeline with a number of partners interested in leveraging our data, including pharma, CRO, and health plan customers.

We are very excited about our acquisition of Med Exam. This will give us access to more mobile health care professionals, which expands our scale and reach in the mobile and home segments, as well as bolstering our overall capabilities in extended care.

The second element of our two-point strategy is to drive operational excellence. I'm pleased to report that we exceeded our $1.3 billion goal of cumulative run rate Invigorate savings as we exited 2017.

We will maintain our discipline in this area, continuing to drive efficiency and effectiveness. Every year we need to cover the cost of wage inflation and price compression.

Given our track record of delivering in this area over many years, going forward we will provide periodic updates on our progress in lieu of a specific run rate savings goal.

Quality and efficiency go hand in hand, and as we drive operational efficiency, we continue to improve the customer experience.

More than half of our 2,200 PSCs are live with e-Check-in kiosks, which improve the patient experience. By the end of the year we expect to have that capability in nearly all of our locations.

E-Check-in enables our phlebotomists to spend less time on clerical tasks and more time delivering a better patient experience.

Turning to our outlook, our guidance for full year 2018 reflects expectations for continued acceleration of top-line growth of 4 to 5 percent and more than 20 percent adjusted earnings growth, driven in part by solid mid-to- high single digit adjusted earnings growth from operations.

Now, let me turn it over to Mark, who will take you through our financial performance and 2018 guidance in detail.

Mark Guinan: Thanks, Steve.

Starting with revenues…

Consolidated revenues of $1.94 billion were up 4.1% versus the prior year.

Revenues for Diagnostic Information Services, or DIS for short, grew 4.5% compared to the prior year with approximately 210 basis points attributed to acquisitions.

Volume, measured by the number of requisitions, increased 2.4% versus the prior year with acquisitions contributing approximately 150 basis points in the quarter. The lingering impact of Hurricane Maria on our operations in Puerto Rico presented a headwind of approximately 20 basis points to volume in the fourth quarter.

Revenue per requisition in the fourth quarter grew by 2.1% 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.

Unit price headwinds remained less than 100 basis points in the fourth quarter, consistent with the trends we observed throughout 2017. Excluding the impact of PAMA, we would expect unit price headwinds in 2018 to remain less than 100 basis points, with PAMA adding an additional headwind of approximately 50 basis points on our DIS segment.

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

Beyond unit price and the impact of growth in our PLS partnerships; other mix elements, including test mix, were strong, contributing more than 200 basis points in the quarter. This trend has remained consistent over the last couple years.

Reported operating income for the quarter was $269 million, or 13.9% of revenues, compared to $276 million, or 14.8% of revenues, a year ago.

On an adjusted basis, operating income was $317 million, or 16.4% of revenues, compared to $305 million, or 16.4% of revenues last year.

Reported EPS was $1.82 in the quarter compared to $1.09 a year ago. The increase is related to a net tax benefit recorded as a result of the recent tax legislation. Adjusted EPS was $1.40, up nearly 7% from $1.31 last year.

The company recognized an after-tax net benefit totaling $74 million in the quarter. This primarily reflects the tax benefit mentioned previously, partially offset by system conversion, restructuring, integration and other charges. The net impact of these items increased our reported EPS by 53 cents.
Our reported fourth quarter tax rate was significantly lower than the prior year as a result of tax reform. In the quarter we recorded approximately 2 cents per diluted share of excess tax benefit associated with stock based compensation, or ETB, compared to approximately 1 cent per share benefit last year. In the full year 2017, we recorded 27 cents per share of ETB, which is an increase of 21 cents year over year.
At this point, I would like to highlight that, beginning in 2018, we will exclude ETB from our adjusted EPS calculation. We believe this change will provide you with additional insight into the operational performance of our business.

Bad debt expense for the fourth quarter as a percentage of revenues was 3.8%, 20 basis points higher than last year and 20 basis points lower versus the prior quarter. For the full year 2017 bad debt was 4.1%, flat year over year. As a reminder, beginning in 2018, new revenue recognition rules will require us to classify uncollectible balances associated with patient responsibility as a reduction in net revenue as opposed to bad debt expense. As you think about 2018, consider the impact of this change on our revenue for each quarter of 2017, which is shown in note 8 at the end of this morning's earnings press release. You should use these adjustments as the basis for comparability in 2018. The reduction in revenue for each quarter of 2017 is accompanied by an equal reduction in SG&A expense, with no impact to operating or net income.

Turning to cash provided by operations, we generated $1.2 billion in 2017 versus $1.1 billion last year. Capital expenditures during the year were $252 million, compared to $293 million a year ago.

Now, turning to guidance. We are providing the following outlook for 2018:

- Revenues to be between $7.70 billion and $7.77 billion, an increase of 4 to 5% versus the prior year
- Reported diluted EPS to be between $5.42 and $5.62 and adjusted EPS excluding both amortization and ETB, to be between $6.50 and $6.70.
- Cash provided by operations to be approximately $1.3 billion; and
- Capital expenditures to be between $350 million and $400 million.

Here are some items for you to consider, given all the moving pieces in 2018:

- First, as a result of tax reform we expect our effective tax rate in 2018 to be approximately 24%. We expect to realize approximately $180 million in adjusted tax savings. Of this amount we expect to deliver roughly $120 million after tax, or approximately $0.85 to our adjusted EPS in 2018. Additionally, we intend to reinvest approximately $75 million before tax of the benefit to support our 2-point strategy. From a cash perspective, we expect our lower tax rate to increase cash from operations by approximately $160 million in 2018

- Second, we expect unit price reimbursement pressure on our DIS segment to remain less than 100 basis points, excluding PAMA, with an additional headwind of approximately 50 basis points including PAMA. Recall, in November we sized the impact of PAMA as approximately 4% of our 2018 Medicare revenue from the clinical lab fee schedule and approximately 10% in both 2019 and 2020. Our forecasted impact on the business over the next three years from the fee schedule reduction remains unchanged.

- Third, our revenue guidance of 4 to 5% growth includes only the M&A that we've closed to date, including Med Exam. We estimate the revenue impact of recently closed acquisitions as well as carryover from acquisitions that closed earlier in 2017 at roughly 2.5% in 2018. The earnings accretion from these deals will ramp throughout 2018 and into 2019.
- Fourth, our 2018 revenue guidance reflects the classification of patient related bad debt against revenue in accordance with the new revenue recognition standard.

- Fifth, as Steve noted earlier, we exceeded our $1.3 billion goal of cumulative run rate Invigorate savings through the end of 2017. Our efforts around Invigorate will continue indefinitely, as they should. Best in class organizations can take out at least 3% of costs per year. We believe Quest is a best in class organization and will continue to drive operational excellence that drives annual efficiencies of this magnitude. As Steve mentioned, given our track record of delivering in this area, going forward we will provide periodic updates in lieu of a specific run rate savings goal.

- Sixth, as I highlighted earlier and as noted in our earnings release, beginning in 2018 we will exclude ETB from our adjusted EPS calculation. For historical comparisons, our adjusted EPS results for 2016 and 2017 included 6 cents and 27 cents of ETB, respectively.

- Seventh, the increase in our capex guidance reflects in large part the planned start of our multi-year new lab construction in New Jersey, additional investments in our advanced and consumer growth strategies, as well as final buildout costs associated with our headquarters move to Secaucus.

- And finally, as you think through your models for the first quarter of 2018, please note that to date we have already experienced nearly as much weather impact as we did in the entire first quarter of 2017.

Before I turn it back to Steve, I'd like to provide some final comments on our capital allocation philosophy and 2020 outlook.

Our capital deployment philosophy has served us very well over the last several years and remains unchanged. We expect to continue to return the majority of free cash flow to shareholders through dividends and buybacks. We continue to prefer to use the remainder of free cash to fund M&A activity, which we believe will be more robust over the coming quarters in light of PAMA.

With regards to our 2020 outlook, we remain confident in the targets that we've outlined for 2017 through 2020. These targets include a revenue CAGR of 3-5%, with 1-2% growth expected from acquisitions and an adjusted earnings CAGR faster than revenue in the mid-to-high single-digit range.

Last quarter, we shared that this outlook implied adjusted EPS in the range of $6 to $7 by 2020. We also shared at that time that we would expect to be toward the lower end of this range given the reimbursement cuts associated with PAMA. While the cumulative PAMA headwind through 2020 remains severe, we now believe we will exceed $7 in light of tax reform.

I will now turn it back to Steve.

Steve Rusckowski: Thanks, Mark.

To summarize a very busy and productive quarter:

We delivered a strong fourth quarter.

- **In 2017 we made great progress accelerating growth and driving operational excellence.**
- **Our guidance for full year 2018 reflects expectations for continued acceleration of top and bottom line growth.**
- **Quest benefits from tax reform and we are investing in our business and our people.**

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.