Quest Diagnostics Incorporated
Conference Call Prepared comments
For the Quarter Ended June 30, 2013

Conference operator: Welcome to the Quest Diagnostics Second Quarter 2013 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.

During this call, we may make forward-looking statements. 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' 2012 Annual Report on Form 10-K and 2013 Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

A copy of 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.

I want to make sure everyone has seen our recent announcements, and want to touch on those briefly.

You've all heard our news announcing our new CFO, Mark Guinan. Mark will be joining us on July 29. Bob Hagemann will remain our CFO until Mark's arrival. Bob has agreed to provide a smooth transition to Mark. Again, I'd like to thank Bob for his years of service to Quest Diagnostics. Given the timing of the transition, we thought it would be best for Dan and myself to handle today's call. We look forward to introducing Mark to all of you during the third quarter.

Second, we announced this morning that we completed the sale of the Ibrutinib royalty rights for $485 million in cash.

We'll talk more about each of these later in the call.

I'd like to take you through the top-line performance; share our thoughts on reimbursement and utilization trends as well as healthcare reform; and review progress against our five point strategy. Then Dan will provide detail on the results.

Since January we have been saying that we anticipated continued revenue softness in the first half of this year and that our efforts to restore growth would result in gradual improvement through the rest of the year. As expected, revenues and earnings improved from the first quarter levels, but were below the prior year. We saw continued revenue softness in the second quarter due to lower healthcare utilization, which impacted many healthcare providers, as well as reductions in our reimbursement.

There are a number of factors that impacted year-over-year comparisons. As you'll hear later from Dan, after considering those factors, our underlying volume was down about 1.5% versus the prior year. This compares to the first quarter, which was down about 2%.

In addition, revenue per requisition decreased 3.7% in the second quarter, primarily due to a combination of Medicare cuts and commercial pricing.

The impact of the acquisition of Concentra's toxicology business contributed approximately 50 basis points of the decrease. We continue to expect underlying revenue per requisition, before acquisitions, to be down about 3% for the full year.

I'd like to discuss reimbursement, utilization pressures and the implementation of the Affordable Care Act, which have been in the news recently.

Last week, CMS proposed significant changes to the Physician Fee Schedule and a mechanism to adjust the Clinical Lab Fee Schedule in the future. Proposed reductions in Medicare reimbursement did not come as a complete surprise.

We have been saying there will be continuing pricing pressure on our industry, and have been preparing for it, and this has been one of the driving forces behind our Invigorate cost reduction initiative.

The cuts proposed by Medicare last week could impact the industry and impact us. Reimbursement from services related to the physician fee schedule for Medicare patients was approximately 3% of our 2012 consolidated revenues. However, the impact will be greater on smaller independent and hospital laboratories because they have a larger portion of Medicare business. I am participating with other industry leaders to proactively work with CMS regarding these proposals.

Last fall at Investor Day, when we introduced our expectation for average annual reimbursement pressure of 1-2% over a 3-year period, we took into account the impact of: known Medicare price cuts; Sequestration; forecasted commercial payer price changes; and potential other government reimbursement changes.

There have also been widespread signs that utilization is softer than last year. Physician office visits and hospital admissions in the first half of 2013 are below the first half of 2012. Additionally, payers have cited lower medical costs as a driver of improved performance.

Finally, turning to the Affordable Care Act, it now seems likely that the expected entry of uninsured people into the healthcare system will ramp up more slowly than initially anticipated. Less than half the states are moving forward with Medicaid expansion, which was seen as a major entry point for the uninsured. In addition, the exchanges are taking longer to develop than originally anticipated.

Finally, the delay in the employer mandate will further slow ACA's implementation. We still believe the Affordable Care Act will be a net positive for the industry and for our company but it will take longer to see the benefits than initially expected.

The long term outlook for this market is attractive for many reasons:

- The population is aging and growing;
- More people will have access to healthcare;
- Advances in genomics and advanced testing will lead to opportunities for personalized medicine;
- Data analytics will help improve quality and reduce cost; and
- This industry continues to consolidate.

We have said before that: 2013 is a building year; that we are making solid progress executing our five point strategy; and that we expect stronger performance in the second half.

The improvement in the second half is expected to be driven by easier comparisons; the impact of acquisitions; the benefit of investments we have made to drive growth; the excellent progress we're making with our Invigorate cost-reduction initiative; and benefits from share repurchases. We believe that the progress we will make this year will position us for a stronger 2014 despite the slower implementation of healthcare reform.

Now I'd like to share a midyear update on progress we are making executing our five point business strategy.

Let's start with driving operational excellence.

The Invigorate cost-reduction initiative is on track to deliver substantial savings this year. To date it has mitigated much of the bottom line impact of the revenue softness.

We are currently on track to deliver more than $250 million in realized savings in 2013 versus 2012. We have shared we expect twice as much in savings in the second half of the year than the first half. In addition, we are tracking very well against our goal to deliver $600 million in run-rate savings by the end of 2014. We are taking advantage of our size and scale to improve quality and are committed to our challenge to increase the $600 million goal to $1 billion beyond 2014.

The progress we are making on our Invigorate flagship programs gives us confidence in the savings that we have projected. Last fall, we indicated that we had a highly complex organization that was not aligned with the market and our two highest priorities, driving operational excellence and restoring growth. This complexity was also inefficient. We said we had too many management layers and would remove between 400-600 management positions, resulting in expected run-rate savings of $80 million.

We have essentially completed the elimination of at least three layers from the organization and have reduced approximately 450 management positions from the company to date, with approximately another 50 reductions to come by the end of the year. We are on track to achieve our expected run-rate savings goal.

Invigorate initiatives are enabling us to do a better job driving efficiencies in purchasing; centralizing support functions so we can provide better customer service; and rationalizing excess capacity in our laboratory network.

We are also standardizing the way we manage data, use common business processes and enable them with enterprise IT systems.

Next, we have taken action to restore growth.

The near term focus is on: Bringing sales and marketing excellence to Quest Diagnostics, Growing esoteric testing through our disease focus; and finally Partnering with hospitals and IDNs. Let's look at each of these elements.

The reorganization of the sales force is complete. We have a different and simpler organization headed by new leaders. We have more sales people who are better trained, equipped, incented and more focused on calling on customers than before.

We continue to make progress with our health plan relationships, and I am pleased that we have extended our relationship with Cigna and look forward to a continued strong partnership with an innovative partner. We have also signed agreements with a number of payers for diagnostic services offered on the new health insurance exchanges that are an important part of healthcare reform.

We are improving the way we introduce new esoteric diagnostic information services, and are developing new service offerings linked to our new disease-focused clinical franchises. We have invested in building seven clinical franchises organized by specialty/disease state, with each led by its own general manager. We believe that this more thoughtful and will bring better solutions to the market which will generate additional growth.

For example, our new Women's Health clinical franchise established our new strategic relationship with Hologic that provides us with the opportunity to ignite new business opportunities with a leader in women's health. This collaboration will focus primarily on cervical cancer and breast cancer.

In addition, following the landmark Supreme Court decision on BRCA1 and 2, we are working to introduce a solution for breast cancer pre-disposition testing later this year.

Our hospital professional services team continues to see interest building from integrated delivery networks. We have increased activity at all phases of the pipeline, from initial discussions to data sharing to diligence and contracting.

All these factors give us confidence we will see results from our efforts build throughout the remainder of the year.

Our third strategy is to simplify the organization

We have deployed our new organization, shared corporate priorities, established new behaviors, and are implementing a new management process, with rewards and incentives.

With our new organization, we now have a new senior management team comprised of executives from the company when I joined in addition to the five new members since last year. These individuals all come from senior positions at major publically traded companies, and bring significant leadership experience.

Notably, we have just announced our new Chief Financial Officer, Mark Guinan. He comes to us with strong financial operations experience. We look forward to his joining us later this month.

I'm now confident that our new senior management team will help instill our new behaviors throughout the company.

Our fourth strategy is to refocus on the core diagnostic information services business.

Late last year, we sold the OralDNA dental diagnostics business. During the first half, we sold HemoCue and began a process to evaluate the Celera drug assets and its products business. We are pleased to complete today the sale of the Ibrutinib royalty rights to Royalty Pharma for $485 million in cash. We continue to hold royalty rights for assets licensed to Pharmacyclics and Merck.

Our portfolio review is resulting in asset sales that are providing additional flexibility for our fifth strategy, which is delivering disciplined capital deployment.

Our plan is to return the majority of our free cash flow to our shareholders in the form of dividends and share repurchases. The sale of HemoCue provided proceeds that helped us repurchase $405 million of shares in the second quarter, bringing year to date share repurchases to $467 million. We plan to use the after-tax proceeds from the sale of the Ibrutinib royalty rights to drive shareholder value, consistent with our capital deployment strategy.

In addition, we completed the acquisitions of the lab outreach business of Dignity Health and Concentra's toxicology business, consistent with our goal of contributing 1-2% revenue growth per year through strategically aligned, accretive acquisitions.

Despite the difficult operating environment, this progress gives us confidence that we are making the appropriate improvements needed, and that we will see the benefits build throughout the remainder of this year and thereafter.

Now I'll turn it over to Dan for detailed analysis of the numbers.

Dan Haemmerle**:** Thanks, Steve.

Starting with revenues…

Q2 consolidated revenues of $1.8 billion were 3.3% below the prior year but 1.6% better than Q1 2013.

Our Diagnostic Information Services revenues, which account for over 90% of total revenues, were 3.6% below the prior year. Volume was essentially flat -- 0.1% better than a year ago. The three acquisitions completed this year (UMass, Dignity Health and Concentra's toxicology business) contributed approximately 1.6% in the quarter to volumes and are all on track versus our growth plans. The contribution from acquisitions was essentially offset by softness in our underlying volumes of approximately 1.5%. While underlying volumes were softer than a year ago, they are approximately 0.5% better than what we experienced in Q1 of this year.

As we have shared previously, we expected to see continued volume softness in the first half of the year, with improvement in the second half due to more favorable year-over-year comparisons and building momentum on our efforts to restore growth.

Revenue per requisition in Q2 was down 3.7% compared to the prior year. The impact of our two recent acquisitions, principally Concentra's toxicology business, lowered revenue per requisition by approximately 0.5%. Excluding the impact of these acquisitions, our underlying revenue per requisition was lower than prior year by approximately 3.2%. This 3.2% reduction in underlying revenue per requisition is largely due to the Medicare fee schedule reductions, including pathology reductions, that went into effect on January 1st, plus the 2% Medicare Sequestration reductions implemented on April 1st as well as certain commercial fee schedule changes.

Consistent with the first quarter, positive test mix is essentially being offset by business mix. As we have shared previously, we continue to expect that for the full year the underlying reimbursement decline will average about 3%, with about 1% of the year-over-year impact we saw in the first half of the year expected to anniversary later in the year. And over the next several years, we continue to plan for average annual reimbursement pressure of 1%-2% through 2015.

Q2 revenues in our Diagnostic Solutions businesses, which include risk assessment, clinical trials, healthcare IT, and our remaining products businesses, were flat compared to the prior year. This is a sequential improvement from the first quarter performance that was down about 2% compared to the prior year.

Adjusted operating income was 16.9% of revenues, about 1.7% below the prior year, with the decrease principally due to lower revenues. A significant portion of the lower revenue is being offset by continued progress with our Invigorate initiative.

Adjusted EPS of $1.06 was $0.09 below the prior year, with the decrease principally due to lower revenues, partially offset with cost savings realized from Invigorate.

As a result of the company's ongoing efforts to drive operational excellence and simplify the organization, restructuring and integration costs totaling $19 million reduced reported operating income as a percentage of revenues by 1.0% and reported EPS by 7 cents. Last year the second quarter included $15 million of costs associated with restructuring, integration, and CEO succession, which reduced reported operating income as a percentage of revenues by 0.9% and reported EPS by 6 cents.

Bad debt expense as a percentage of revenues was 3.7%, or 20 basis points higher than the prior year. DSOs were 48 days, up two days from last quarter. The increase in DSOs can be principally related to payment delays in connection with obtaining new provider numbers associated with recent acquisitions. We expect these issues to be resolved later this year.

Cash from operations was $208 million in the quarter compared to $251 million in the prior year. Lower cash from operations is largely due to the increase in DSOs, which we expect to reverse in the second half of the year.

Capital expenditures were $56 million in the quarter, compared to $47 million a year ago.

During the quarter we repurchased 7.2 million common shares, at a price of $55.92 for a total of $405 million dollars. As expected we deployed the proceeds received from the HemoCue disposition into share repurchases in the second quarter.

Turning to guidance:

We continue to expect results from continuing operations, before special items, as follows:

- Revenues to be 1% to 2% below 2012. Prior guidance was to approximate the prior year level;
- Earnings per diluted share to be between $4.35 and $4.50, compared with prior guidance of $4.35 to $4.55;
- Cash provided by operations to approach $1 billion compared to prior guidance that it would approximate $1 billion;
- And capital expenditures to approximate $250 million.

In considering the full year guidance in the context of the first half performance it is important to keep in mind several factors:

- As we've previously indicated, the comps versus the prior year will become more favorable in the second half of the year. While the number of business days, coupled with the weather effect, adversely impacted revenue comparisons in the first half of the year, those same factors are expected to contribute to favorable year over year comparisons in the second half of the year and be essentially neutral for the full year.
- Underlying revenue per requisition, which was down approximately 3.3% in the first half versus the prior year, is expected to be down about 3% for the full year, with about 1% of the impact we saw in the first half to anniversary later in the year.
- Our three acquisitions contributed approximately 1% to revenues in the first half of the year and we expect those acquisitions to contribute approximately 2% in the second half of the year.
- Our efforts to restore growth are gaining traction and we expect to see increasing progress as the year unfolds. We saw a 0.5% improvement in year-over-year underlying volume from Q1 to Q2, and expect it to continue to improve in the second half.
- Lastly, as Steve mentioned, we expect to see approximately twice the benefit from Invigorate in the second half as we saw in the first half.

For all these reasons, we have confidence in the expected performance improvement during the remainder of the year required to achieve our full year guidance.

Now I'll turn it back to Steve.

Steve Rusckowski: Thanks, Dan.

To summarize:

- We see 2013 as a building year, as we improve operations and begin to restore growth.
- We are executing well on each element in our five point strategy.
- The second half of 2013 will show improvement for many reasons, which we have discussed.
- We continue to have confidence that executing our five point strategy will drive increased value for shareholders over the long term.

###