Q1 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 now excludes excess tax benefits associated with stock based compensation. Also, net revenues and selling, general and administrative expenses have been restated for the basis of prior year comparisons to reflect the impact of new revenue recognition rules that were effective January first, 2018 and were 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 some perspective on PAMA, highlights of the quarter and review progress on our 2-point strategy which continues to drive results. Then Mark will provide more detail on first quarter performance.

We delivered strong revenue growth despite the negative impact of severe weather and lower Medicare reimbursement under PAMA.

Earnings growth was driven by continued strong execution as well as the benefits of tax reform. We also completed our previously announced acquisition of MedXM, which is off to a good start.

Here are some key highlights from the quarter:

- Revenues were up 3.7 percent;
- Reported EPS was up nearly 10 percent from 2017. Adjusted EPS grew 25 percent.

Before I describe the progress we have made, I'd like to provide an update on PAMA and our investments in the business using a portion of savings from tax reform.

Turning to PAMA, this was our first quarter operating under the new Clinical Lab Fee Schedule, which accounted for approximately 12% of revenues last year. Since November we've said we expected the impact of the final rates under PAMA would be a reduction of approximately 4% in 2018, and approximately 10% in both 2019 and 2020. Our actual Medicare reimbursement in the first quarter re-affirms our projected impact for 2018.

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 initial briefs to the court, and we still believe we could have a decision from the judge by mid-year.

We want to reiterate that ACLA's complaint is not challenging the new Medicare rates themselves, but rather the process CMS followed to arrive at those rates.

As the lawsuit progresses, ACLA is continuing to seek a legislative fix to PAMA, coordinating closely with aligned trade associations like NILA, AdvaMedDx, and other stakeholders.

This issue is about ensuring that Medicare beneficiaries have access to critical lab services. While the new rates have impacted us, other lab providers, including many serving in remote and underserved areas, may be forced to close their doors. That's why this is an important issue.

Turning to tax reform, last quarter we shared with you that we will realize approximately $180 million in tax savings on an adjusted basis in 2018. We are reinvesting roughly $75 million before tax back into the business, and our people, much of which is underway.

Turning to the first 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% through strategically aligned, accretive acquisitions, which we achieved for the fifth consecutive year in 2017.

We had a productive quarter for M&A. We completed our acquisition of MedXM, a leading national provider of home-based health risk assessments and related services. More on this acquisition in a few moments.

We are integrating the acquisitions announced in the latter half of 2017, and are pleased by the results. As we guided earlier in the year, we expect to deliver about 250 basis points of growth from M&A in 2018 which is above the top end of our 1%-2% objective.

Our M&A pipeline remains strong, and our strategy is delivering growth.

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

In March we entered into a professional lab services relationship with an integrated healthcare delivery system in New England.

We acknowledged earlier that PAMA is a headwind for us. However, reimbursement cuts are a bigger headwind for hospital systems operating outreach labs. Hospital executives are starting to become more aware of the impact of PAMA, and we are having more frequent conversations with them about their lab strategy and how we can help.

Many of you have asked about the possibility of expanding our access within major health plans. We continue to have productive conversations and make progress with a number of payers.

Quest offers health plans and their members' unmatched convenience, access, quality and value. Based on recent conversations, it is clear that many health plan leaders agree.

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

Key growth drivers in the quarter were Prescription Drug Monitoring, Quantiferon, and noninvasive prenatal screening.

In advanced diagnostics, we are making strong progress with our new center of excellence in precision medicine and oncology in Texas.

This center is helping community oncologists determine the most appropriate treatment of patients with cancer.

Since we acquired MedFusion we have seen an acceleration of growth in molecular tumor panels. Seventy percent of cancer patients are treated by community cancer centers, and we are excited about the opportunities Med Fusion is creating with networks of community cancer practices like the U.S. Oncology Network and Texas Oncology, as well as with Baylor Scott & White Health, the largest health system in Texas.

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 perform very well, with an increase in patient traffic across the board and outstanding feedback on the customer experience.

- We are expanding into different markets, and expect to open many more locations throughout the year.

- We are pleased with the progress and excited about the future of this important partnership with Walmart.

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

The integration of MedXM is going well. Customers are excited that we can help them close critical gaps in care using our mobile health care professionals to reach patients when and where it's convenient for them.

Here's one example of how this capability is closing gaps in care…

- Diabetic eye screening is a key part of diabetes care.

- MedXM's national health plan customers identify at risk Medicare Advantage or Managed Medicaid members.
- MedXM call centers then reach out to patients to schedule a health risk assessment to visit the patient and perform a series of tests which includes capturing a retinal image.
- This program helps identify people at risk of diabetes and enables health plans to improve their quality scores.

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

Earlier this month we launched a pilot program with Humana, Multiplan, Optum, and UnitedHealthcare to use blockchain technology to improve the quality of health care provider data and reduce administrative costs. We look forward to contributing our data and expertise to a project which we believe can lower cost and improve efficiency within the health care system.

We are continuing to drive efficiency and effectiveness within Quest to cover the cost of wage inflation and reimbursement pressure.

Here are a few updates:

- Our collaboration with Optum 360 continues to perform well. As consumers bear an increased share of the cost of their health care, more of our revenues come from patients, which poses collection challenges. Despite the pressure from increasing patient responsibility, we are succeeding in keeping uncollectible balances associated with patient responsibility in line with last year.
- We are collaborating with payers to bring price transparency to health care through our Real Time Estimation tool. This tool enables a health plan member at our patient service center to know before a specimen is drawn if the test is covered, and what out-of- pocket cost the health plan member will pay for the test.

We continue to e-enable the business to improve the customer experience.

- Our eCheck-In process has been used in more than 27 million patient encounters. Our patients like the convenience, and this information helps us to place phlebotomists where they are needed most based on patient flow. We have over 1,500 sites with eCheck-In, and expect to deploy it in all of our PSCs by the end of 2018.

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

Mark Guinan: **Thanks, Steve.**

Starting with revenues…

Consolidated revenues of $1.88 billion were up 3.7% versus the prior year. Please note that due to a change in revenue recognition accounting, we now report uncollectible balances associated with patient responsibility as a reduction of net revenues instead of bad debt.

Revenues for Diagnostic Information Services, or DIS for short, grew 4.1% compared to the prior year with approximately 340 basis points attributed to acquisitions.

Volume, measured by the number of requisitions, increased 2.2% versus the prior year driven by acquisitions, with organic growth essentially flat; volume was negatively impacted by weather and the timing of major holidays during the quarter.

The impact of weather presented a volume headwind of 60 basis points. The timing of the Easter and Passover holidays this year versus last year weighed on first quarter requisition volumes and created a tougher year over year comparison.

Revenue per requisition in the first quarter grew by 1.6% 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 during the quarter were approximately 50 basis points from PAMA and less than 100 basis points from all other factors. This is consistent with the outlook we provided in February and in line with the trends we've observed for several quarters.

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 $272 million, or 14.5% of revenues, compared to $279 million, or 15.4% of revenues, a year ago. On an adjusted basis, operating income was $303 million, or 16.1% of revenues, compared to $297 million, or 16.3% of revenues last year. Operating income decreased by $8 million compared to the prior year as a result of weather. The decline in operating margin was caused by a mix of PAMA, weather, and acquisitions, which are in early stages of integration and therefore not yet delivering full margin contribution.

Also, as Steve mentioned we are using a portion of our savings from tax reform to reinvest into the business and our people. We expect these investments to help us continue to accelerate growth, which also impacted operating margin this quarter.

Reported EPS was $1.27 in the quarter compared to $1.16 a year ago. Adjusted EPS was $1.52, up roughly 25% from $1.22 last year. Note that our adjusted EPS now excludes excess tax benefits related to stock based comp to provide greater clarity into the underlying operational performance of our business.

Our effective tax rate in the first quarter was approximately 23% compared to 32% last year.

As I mentioned earlier, our uncollectible balances associated with patient responsibility are no longer reported in selling, general and administrative expense. That said, we intend to provide periodic updates on the progress we continue to make with our revenue cycle management partner, Optum 360. In the first quarter, our uncollectible balances associated with patient responsibility are flat year over year.

Cash provided by operations in the first quarter was $180 million versus $196 million last year. The year over year difference was largely due to movements in working capital accounts.

Capital expenditures during the quarter were $73 million, compared to $42 million a year ago which is in line with the higher capex spend planned for 2018.

Now, turning to guidance. Our outlook for 2018 remains unchanged as follows:

- 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, 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.

Recall that our guidance includes only the acquisitions that we've closed to date. Recall, we closed several acquisitions in the back half of 2017. We expect the earnings accretion from these deals to continue to ramp throughout 2018 and into 2019.

I will now turn it back to Steve.

Steve Rusckowski: Thanks, Mark.

To summarize:

- **We delivered a strong first quarter.**
- **We made solid progress accelerating growth and driving operational excellence.**

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.