Q2 2016
CONFERENCE CALL SCRIPT
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Conference operator: Welcome to the Quest Diagnostics Second Quarter 2016 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 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 president and chief executive officer, and Mark Guinan, our Chief Financial Officer. During this call, we may make forward-looking statements and also discuss non-GAAP measures. For this call, references to adjusted EPS refer to adjusted diluted EPS excluding amortization. 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' 2015 Annual Report on Form 10-K, quarterly reports on Form 10-Q and Current Reports on Form 8-K.

The text of our prepared remarks and a PowerPoint presentation will be available later today in the Investor Relations page of our website.

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, share a few comments on industry dynamics, and review progress on our five-point strategy. Then Mark will provide more detail on the results and take you through guidance.

During the second quarter:

- Revenues declined 1% on a reported basis related to our efforts to refocus the business, but grew 2.4% on an equivalent basis;
- Reported EPS grew more than 69% while adjusted EPS grew more than 7%;

Before I get to our strategy update, I'd like to provide perspective on a few key aspects of the final rule implementing provisions of the Protecting Access to Medicare Act or PAMA, issued late last month by the Centers for Medicare and Medicaid Services (CMS).

First, on the issue of timing, we are pleased with CMS's decision to delay the implementation of the new payment system until January 1, 2018, a position advocated by members of Congress, hospitals, and laboratory trade associations.

Second, CMS changed its approach to secure a better view of market pricing. By gathering the pricing data from labs in a different way, CMS will increase the number of labs that provide pricing data.

Finally, we continue to evaluate the impact of this final rule, but we won't have a clear view until we see the final pricing data.

In the meantime, CMS is estimating a mid-single -digit rate reduction in 2018. As you know, the Clinical Lab Fee Schedule represents approximately 12% of our revenues. As we've shared in the past, our Invigorate savings have more than compensated for price headwinds in the market. If there is a fee reduction in 2018 we would be able to manage it.

Now let me shift to the progress we are making on our five-point strategy, which is to:

- Restore growth;
- Drive operational excellence;
- Simplify the organization;
- Refocus on our diagnostic information services business; and
- Deliver disciplined capital deployment.

Let's start with growth.

We delivered solid volume growth across a number of areas, including prescription drug monitoring, Hepatitis C testing, and CardioIQ, which provides a more complete picture of a patient's cardiovascular health than basic cholesterol testing.

We also grew in the second quarter with help from our new hospital services agreements.

Our acquisition of the outreach laboratory service business of Clinical Laboratory Partners (CLP) and professional lab services agreement with Barnabas Health are helping us deliver the continued execution of our accelerating growth plan.

Additionally, in this quarter we announced an agreement to manage in-patient laboratory operations for six Denver-area hospitals in the HealthONE system of HCA Healthcare. We expect to see revenues from this engagement before the end of the year.

Hospitals continue to talk to us about how we can help them execute their lab strategy, from advanced hospital reference testing to lab management, to joint ventures and outreach lab purchases. Our pipeline remains strong and we continue to be encouraged by the growth opportunities.

In advanced testing, we strengthened our service offering, which includes gene based and esoteric tests.

- During the quarter we announced the availability of three new Quest Vantage™ cancer tests, designed to provide clinically actionable insight into an individual's risk of developing hereditary forms of cancer. These new offerings will better position us in this exciting and growing marketplace.

- We piloted a program this quarter with Non-Invasive Prenatal Screening to serve women of average risk in select regions. Encouraged by the results, we are now offering the testing nationally.

We continued to drive Operational Excellence, the second element of our strategy.

We believe quality and efficiency go hand in hand and we have strong evidence of demonstrated improvement in our customer experience as we make our business more efficient.

As we deliver cost savings we are also improving quality and service. This is a well-understood principle of total quality management approaches across all industries. Evidence of this can be seen in a recent independent, blinded survey of more than 500 physicians, Quest scored highest on customer experience, lab effectiveness and patient satisfaction among national, regional and hospital competitors.

Our recent agreement with Safeway will make it easier for people to get tested by locating our patient service centers in high-traffic Safeway supermarkets. By expanding patient access through our relationships with retailers, we will optimize our real estate footprint and have an opportunity to reduce the number of unfilled test orders, which some suggest could be as high as 30%.

We're also shrinking our real estate footprint by consolidating our corporate sites. In June we announced the relocation of our corporate headquarters and support functions from Madison and Lyndhurst, N.J. to a single location when our current ten year leases expire in September 2017. By consolidating our footprint we will enable greater collaboration and performance while realizing savings in operating expenses.

Our Invigorate cost savings program continues on track to realize $1.3 billion in run rate savings as we exit 2017.

We continue to Simplify and strengthen our organizational capabilities, the third element of our strategy.

Also this quarter we were proud to be recognized as one of only 100 companies named to the Forbes® 2016 America's Most Trustworthy Companies list, the only company from the diagnostic services industry to be included.

The fourth element of the strategy, to Refocus on our Diagnostic Information Services business, was completed in May following the completion of the sale of the Focus Diagnostics products business.

Proceeds from the sale of Focus Products were used to drive the fifth element of our strategy, delivering disciplined capital deployment. We launched a $250 million Accelerated Share Repurchase program (ASR) with the Focus proceeds, and since 2012 we have repurchased approximately $2 billion of the company stock.

Additionally, in May we issued $500 million in debt to take advantage of favorable interest rates and refinance a portion of our debt.
We look forward to sharing more detail on our market views and strategic outlook at our third Investor Day in New York City on November 11th. So, mark your calendars…and we'll be providing you with more information.

Now, Mark will provide an overview on our second quarter financial performance and provide you with an update on our 2016 outlook.

Mark Guinan: Thanks, Steve.

Starting with revenues…

Consolidated revenues of $1.91 billion were lower by 1% versus the prior year on a reported basis. Equivalent revenues grew 2.4% for the company.

Revenues for Diagnostic Information Services, or DIS for short, grew by 2.2% compared to the prior year.

Volume, measured by the number of requisitions, increased 1.9% versus the prior year. Of the 1.9%, approximately half came from organic growth and the other half from recent acquisitions, including both CLP and MemorialCare. Through the first half of 2016, organic volume is up nearly 2%, a solid increase compared to the slight decline reported in the first half of 2015.

Revenue per requisition in the second quarter increased 0.2% versus a year ago. As a reminder, a number of different elements impact revenue per req including unit price variation, business mix, and tests per req. Price headwinds were in line with our expectations, down slightly less than 1%. As we noted last quarter, our Professional Lab Services, or PLS, engagements such as Barnabas Health and HCA carry lower revenue per requisition due to the nature of the work we are performing. In Q2 2016, the year over year impact of growth in PLS was approximately 120 basis points on our aggregate revenue per req.

In the second quarter, PLS was a larger mix of our business, and as we move through the year we expect PLS to grow at a faster rate than the balance of our business.

Reported operating income for the quarter was $422 million, or 22.1% of revenues, compared to $301 million, or 15.6% of revenues, a year ago. On an adjusted basis, operating income was $324 million, or 17% of revenues, compared to $321 million, or 16.7% of revenues last year. Adjusted operating income benefitted from stronger revenues and our Invigorate initiative, slightly offset by lower margins related to recent acquisitions, our growing professional lab services business, and our efforts to refocus the company. The impact of our clinical trials and products businesses in the second quarter of 2015 benefitted adjusted operating margins by approximately $15 million.

As a reminder, the clinical trials business now appears on the equity earnings line. Also, we no longer have operating earnings associated with the Focus Products business, and recall that we used the proceeds to repurchase shares. In total, our portfolio divestitures represented $169 million of revenues that were excluded to get to our equivalent revenues for 2015.

Reported EPS was $1.37 in the quarter compared to $0.81 a year ago. The significant year-over-year increase was driven in large part by the gain on the sale of our Focus Diagnostics products business in the second quarter and charges on retirement of debt in the prior year. Adjusted EPS was $1.34, up from $1.25 last year.

The company recorded special items with an after-tax benefit totaling $17 million in the quarter, representing a $34 million gain on sale of the Focus Products business, offset by approximately $17 million of primarily restructuring and integration charges. The net impact of these items increased our reported EPS by 12 cents.

Bad debt expense as a percentage of revenues was 4.2%, 40 basis points better than the previous quarter and 10 basis points higher than 2015. As a reminder, bad debt expense typically improves modestly throughout the year as patients hit their health insurance deductibles. Note that the year-over-year compare is negatively impacted by the fact that our clinical trials and products businesses had a lower associated bad debt rate. When taking this into consideration, our bad debt rate year over year improved slightly.

Our DSOs were 47 days, 3 days higher than last year and the prior quarter. This is driven by the timing of certain cash receipts, and we expect our DSOs to come down to levels similar to the prior year in Q3.

Through the first half of 2016, reported cash provided by operations was $464 million versus $337 million last year. Excluding charges associated with early debt retirement in the first half of 2016 and debt refinancing in the first half of 2015, adjusted operating cash flow was $502 million through June 30 in 2016, up from $464 million in 2015.

Capital expenditures were $104 million in the first half, compared to $117 million a year ago.

Before moving to guidance, I'd like to mention a few items for you to keep in mind to help you understand our outlook for the remainder of the year.

First, the year over year impact of the contribution of our clinical trials business to the Q Squared JV on our reported revenues ended in the second quarter of 2016. Recall, this transaction commenced at the beginning of our third quarter 2015.

Second, for the Celera products business that we wound down toward the end of last year, we recognized nearly half of the 2015 revenues and operating earnings for this business in the third quarter of 2015 as customers executed their last-time buys. This will set up a difficult compare in the third quarter this year. As you think about the split for the remainder of the year, last year we had approximately $10 million on a reported basis, and $12 million on an adjusted basis, of Celera Products operating income in Q3 and nothing in Q4.

Finally, there are two notable items on our full year reported operating cash flow projections.

- The first relates to after tax cash charges of $29 million from the retirement of debt that will impact 2016 operating cash flow.
- Second, we will incur a cash tax outlay of $91 million associated with the Focus divestiture that will be recorded in our operating cash flow despite recognizing the associated $275 million from the sale in our investing cash flow.
- Therefore, our adjusted operating cash flow for 2016 will exclude both items.

Having noted these items, our 2016 outlook is as follows:

- Revenues to be between $7.47 billion and $7.54 billion, flat to an increase of approximately 1% versus the prior year on a reported basis, and an increase of 2-3% on an equivalent basis.
- Reported diluted EPS to be between $4.18 and $4.33. Adjusted EPS to be between $5.02 and $5.17.

- Cash provided by operations to be approximately $880 million on a reported basis and roughly $1 billion on an adjusted basis; and finally
- Capital expenditures to be between $250 million and $300 million.

Now, let me turn it back to Steve.

Steve Rusckowski: Thanks, Mark.

To summarize:

- **We built on our good start in 2016 with another solid performance in the second quarter. Revenues grew more than 2% on an equivalent basis;**
- **Adjusted EPS grew more than 7%;**
- **We continued to generate strong cash from operations.**
- **And we remain on track to meet our commitments for the remainder of the year**

STEVE: Thanks again for joining our call today.

- We are making good progress executing our five point strategy.
- Thank you for your time and have a good day.