Q1 2017
CONFERENCE CALL SCRIPT
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Conference operator: Welcome to the Quest Diagnostics First Quarter 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 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' 2016 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 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 and review progress on our strategy. Then Mark will provide more detail on the results and take you through updates to our 2017 guidance.

We began 2017 with a strong first quarter across the board, growing revenues, EPS, operating income, margins and operating cash flow.

Here are some key highlights:

- Revenues were up approximately 2 percent on a reported basis and 3 percent on an equivalent basis;
- Reported EPS of $1.16 increased 63% from 2016. Adjusted EPS grew approximately 18% to $1.33, which includes 11 cents of excess tax benefit associated with our employee stock-based compensation. More on this later from Mark.
- Cash from operations increased 28% to $196 million.

Before I describe the progress we have made to accelerate growth and drive operational excellence, I'd like to briefly discuss PAMA.

CMS postponed the deadline for labs to report private commercial payer pricing data under PAMA for 60 days until May 30.

We fully support the decision. However, we continue to have some concerns about the current definition of “applicable laboratory,” which are those labs required to report private commercial payer data.
According to the Office of Inspector General’s analysis, the current definition of applicable laboratory would cover only 5 percent of labs, representing only 69% of Medicare payments for lab tests in 2015.

While we support reform of the Medicare payment system, we believe any modifications should be market based and appropriately include all applicable independent and hospital outreach laboratories.

Now, let’s review progress we’ve made.

As we detailed at our Investor Day in November, our two point strategy is to accelerate growth and drive operational excellence.

We grew revenue in the quarter, in part by continuing to expand relationships with hospital health systems.

- Our existing Professional Lab Services relationships, including RWJBarnabas in New Jersey, HCA in Denver and most recently Monteifiore in New York City, are performing better than expected, and our pipeline for new relationships remains strong.
- During the first quarter we announced the acquisition of the outreach operations of PeaceHealth Laboratories and expect to close in the second quarter. In addition, after the close, we will execute a professional laboratory services agreement, to manage 11 PeaceHealth laboratories serving medical centers in three states in the Pacific Northwest.
- We are partnering with health plans to improve the patient experience by improving price transparency which will also reduce our bad debt. Our real-time payment determination, which we began piloting in early 2016, enables us to give patients an accurate picture of their financial responsibility for lab testing and allows patients to pay at the point of care. We’re currently live with Aetna, Highmark, UPMC and Florida Blue, and we expect to have more major payers in place by the end of the year. This service benefits Quest, and the entire healthcare system – patients, providers and payers.
- Advanced diagnostics, which generally includes our genetic and molecular-based tests, grew in the quarter, along with non-routine testing.
    - Major drivers included: Q-Natal genetic carrier screening, prescription drug monitoring, and Hepatitis C and Quantiferon TB testing.
    - In the quarter we also announced the launch of a new test service that helps physicians evaluate a patient's response to drug therapies used to treat infection with the hepatitis B virus (HBV). The first test of its kind available in the United States, physicians can use it to tailor more effective treatments for the up to 2.2 million individuals infected with HBV.
- We also made progress executing our strategy to be the provider of choice for consumers.
    - In late January we began providing genotyping for AncestryDNA, a service that today identifies and quantifies an individual's ethnic origins based on results of DNA testing. We are pleased with the initial execution of this program, and look forward to building on our relationship with Ancestry.
    - We continue to expand our relationship with Safeway and are now operating in 65 stores. Consumer and employee satisfaction remain high, and we are on track to open a total of 200 patient service centers in Safeway stores by the end of 2017.

We continue to drive operational excellence, and remain on track to deliver $1.3 billion in run-rate savings as we exit 2017.

- Our revenue services partnership with Optum is on track in helping us to drive down bad debt and denials.

As we have often said, quality and efficiency go hand in hand. We continue at near six sigma levels in many areas, and in the quarter we made year over year gains in many quality measures, including reduced PSC wait times and improved test turnaround times.

We expect our commitment to e-enable our processes will deliver results. We expect to cut paper requisitions by 50% by the end of 2017, and will enable patients to check-in electronically at roughly half of our PSCs by the end of the year. Additionally, we expect our lab systems to be 85% standardized by the end of the year.

We received some meaningful recognition in the quarter, once again being named one of the "World's Most Admired Companies" by Fortune magazine. Quest was one of only six companies in the "Health Care: Pharmacy and Other Services" industry, and the only diagnostic information services company, to attain Most Admired status.

Looking forward to the remainder of 2017, we are well positioned to continue to accelerate growth and drive operational excellence. We have the right strategy and the right team to execute and create value for shareholders.

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

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Mark Guinan: Thanks, Steve.

Starting with revenues…

Consolidated revenues of $1.9 billion were up 1.9% versus the prior year on a reported basis while equivalent revenues grew 3.0%.

Revenues for Diagnostic Information Services grew by 3.2% compared to the prior year. Most of this growth was organic, with approximately 90 bps attributed to the 2016 acquisition of Clinical Laboratory Partners.

Volume, measured by the number of requisitions, increased 3.5% versus the prior year, of which 2.6% was organic. The year-over-year impact of weather was negligible in the quarter.

Revenue per requisition in the first quarter decreased by 20 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.

Unit price headwinds in the first quarter continued to be moderate and less than 100 basis points. We note that price fluctuations can vary from quarter to quarter but we continue to expect that unit price headwinds will remain consistent with the last few years.

Beyond unit price and the impact of growth in our PLS partnerships, other mix elements, including test and payer mix, contributed more than 1% to revenue per req in the quarter.

Reported operating income for the quarter was $279 million, or 14.7% of revenues, compared to $257 million, or 13.8% of revenues, a year ago. On an adjusted basis, operating income was $297 million, or 15.6% of revenues, compared to $281 million, or 15.1% of revenues last year.

Keep in mind, our Focus Diagnostics products business contributed approximately $8 million of adjusted operating income in the first quarter of 2016. Excluding the impact of Focus, adjusted operating income would have grown approximately 9 percent and adjusted operating margin would have increased 80 basis points year over year, consisting of 30 basis points of operating margin tied to Focus and 50 basis points of adjusted operating margin growth.

Reported EPS was $1.16 in the quarter compared to $0.71 a year ago. The prior year quarter included a charge of $30 million after tax, or $0.21 per diluted share, related to the early retirement of debt. Adjusted EPS was $1.33, up 18% from $1.13 last year.

The company recorded after-tax charges totaling $11 million in the first quarter, or 8 cents per diluted share, representing restructuring and integration costs.

Our effective tax rate in the quarter was approximately 32 percent, compared to approximately 39 percent last year. The decrease in the effective tax rate was the result of $16 million, or 11 cents per share, in excess tax benefit associated with stock based compensation, compared to a $2 million, or 1 cent per share benefit, last year.

Bad debt expense as a percentage of revenues was 4.4%, 20 basis points better year-over-year but 80 basis points higher than the fourth quarter of 2016. As a reminder, bad debt expense rate typically increases sequentially in the first quarter due to the reset of patients' health insurance deductibles at the beginning of the year. As in prior years, we expect the bad debt rate to improve gradually throughout the year. Note that the year-over-year compare was also negatively impacted by the fact that our products business had a lower associated bad debt rate.

Cash provided by operations in the first quarter was $196 million versus $153 million last year. Recall, the retirement of debt lowered our operating cash flow by approximately $47 million during the first quarter of 2016.

Capital expenditures during the quarter were $42 million, compared to $47 million a year ago.

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Now, turning to guidance. We are providing the following updated outlook for 2017:

- Revenues unchanged, to be between $7.64 billion and $7.72 billion, an increase of 1.7 to 2.7% versus the prior year on a reported basis, and an increase of about 2 to 3% on an equivalent basis.

- Reported diluted EPS to be between $4.73 and $4.88 and adjusted EPS to be between $5.45 and $5.60.
- Cash provided by operations is also unchanged and remains at approximately $1.1 billion; and finally
- Capital expenditures remain between $250 million and $300 million.

Our increased EPS guidance reflects the higher expected level of excess tax benefit associated with stock based compensation than was included in our previous guidance.

Note that our original EPS guidance assumed a similar benefit in 2017 as we recognized in 2016, or about 6 cents.

As you are well aware, our share price appreciated substantially in 2016, which yielded a significantly higher tax benefit in Q1 2017 based on equity vesting and options exercises.

Our updated reported and diluted EPS guidance for 2017 assumes another 3 cents of benefit over the remainder of the year. However, fluctuations in our share price and option exercise activity could add volatility to this figure.

Going forward, we would expect to experience some level of excess benefit over the next several years. However the timeframe and absolute benefit is difficult to forecast given its dependence on our share price and the timing of option exercises.

Now, let me turn it back to Steve.

Steve Rusckowski: Thanks, Mark.

To summarize:

- **We delivered strong growth across the board in the first quarter with gains in revenues, margins, operating income, EPS and operating cash flow.**
- **Our agreement with PeaceHealth will further bolster growth later in the year.**
- **We are laser focused on our two point strategy to accelerate growth and drive operational excellence.**

Now we'd be happy to take your questions.

STEVE: Thanks again for joining our call today.

- We had a strong quarter and a solid start to 2017.
- We are looking forward to meeting our commitments by accelerating growth and driving operational excellence
- Thank you very much for your continued support.
- Goodbye.