

Quest Diagnostics Incorporated
Q3 2007 Earnings Call Transcript
October 24, 2007

Laure Park: Thank you and good morning. I am here with Surya Mohapatra, our chairman and chief executive officer, and Bob Hagemann, our chief financial officer.

Some of our commentary and answers to questions may contain forward-looking statements. You are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date that they are made and which reflect management's current estimates, projections, expectations or beliefs and which involve risks and uncertainties that could cause actual results and outcomes to be materially different. Risks and uncertainties that may affect the future results of the company include, but are not limited to, the competitive environment, changes in government regulations, changing relationships with customers, payers, suppliers and strategic partners and other factors described in the Quest Diagnostics 2006 Form 10-K, 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 "quarterly updates" section of our website at www.questdiagnostics.com.

A downloadable spreadsheet with our results and supplemental analysis is also available on the website.

Now, here is Surya Mohapatra.

Surya Mohapatra: Thank you, Laure.

During the quarter we continued to grow our revenues, improve margins and generate strong cash flow:

- Consolidated revenues grew to \$1.8 billion;
- Operating margin grew to 17.3%, the second consecutive quarter of strong improvement;
- And, cash flow was strong, approaching \$300 million.

We started the year with uncertainty – in the competitive environment with health plans and our ability to manage costs and grow.

- We have made excellent progress in reducing that uncertainty by renewing and in some cases expanding our relationships with health plans.
- We have aggressively reduced our cost structure while improving service, and returned margins to the levels we realized as a contracted provider to United. We continue to retain approximately 25% of the United business and have seen no change in the associated discretionary work. This is a clear testament to our strong and differentiated value proposition.
- We have also begun to implement plans to further reduce costs by 500 million dollars over the next two years.
- And we have made important acquisitions which position us to accelerate growth.

Later I will elaborate on our growth plans, but first, Bob will review our performance and guidance.

Bob Hagemann: Thanks, Surya.

As Surya indicated, we've continued to make excellent progress in improving margins over the course of the year, and are essentially back to the profitability levels of last year, before considering the acquisition of AmeriPath.

In addition, we have begun discussions with the government in an effort to reach a settlement regarding its investigation of NID, a test kit manufacturing subsidiary closed in 2006. In connection with these discussions, we have established a reserve of \$51 million, and recorded the charge as part of discontinued operations. We have been working diligently to bring closure to this matter, but it remains unclear as to how long it may take and what the ultimate cost will be, to resolve this issue. Given that we are in ongoing discussions regarding this matter, what we can say is limited and is contained in Footnote 8 to the earnings release.

In order to assist in making comparisons, as I go through our results, I'll highlight the impact of AmeriPath on a number of key metrics. In addition, to highlight our progress, I'll point out improvements in certain metrics over the last several quarters.

Revenues were \$1.8 billion, 11.6% above the prior year, with AmeriPath contributing about 13 % growth. Revenues for our clinical testing business, which accounts for over 90% of our total revenues, were 10.6% above the prior year, with AmeriPath contributing 14%. Volume was 2.4% below the prior year, and approximately 8% below without the AmeriPath acquisition. Revenue per requisition increased 13.3%, with 8.5% of the increase due to AmeriPath. The balance of the increase in revenue per requisition continues to be primarily driven by a positive test mix. AmeriPath's organic revenue growth for the third quarter was 7% with particular strength in dermatopathology and hospital testing.

We estimate that consolidated revenues were reduced by almost 5 % due to our change in status with United, with clinical testing volume reduced by about 7%, partially offset by a positive impact to revenue per requisition of about 2%. The positive impact to revenue per requisition is associated with higher reimbursement on the retained United work.

Throughout the third quarter we saw little change in our United volume and continue to remain at about 25% of the previously contracted level. We expect that some additional United volume will move over time due to United's ongoing efforts. We continue to be encouraged by physicians' decisions to select Quest Diagnostics, when given a choice, and have seen no further loss of discretionary work during the quarter.

Adjusted for the change associated with United, we saw about a 1% improvement in our base volume growth compared to that of the second quarter. The improvement principally related to our new Aetna agreement which went into effect July 1.

Organic revenue growth in our non-clinical testing businesses as a group, which include our clinical trials testing business and the risk assessment business was a little over 5% for the third quarter.

The acquisition of HemoCue contributed about one and a half percent to consolidated revenue growth.

Operating income as a percentage of revenues was 17.3% for the quarter, compared to 18.5% in the prior year, with the difference due to the acquisition of AmeriPath. Before including the results of AmeriPath, margins have now returned to the prior year level, only nine months after the contract change with United. This is a further improvement of about two full margin points from the year-over-year comparison in the second quarter, which itself reflected significant improvement from the first quarter comparison. The improvements are due to actions we are taking to reduce our cost structure; the avoidance of certain costs incurred in the first quarter associated with business retention and workforce reductions; and higher revenue per requisition.

Bad debt expense as a percentage of revenues was 4.8%, and 4% before the inclusion of AmeriPath. AmeriPath, which carries a higher bad debt rate than the rest of our business, much of it due to the in-patient work done for hospitals, and billing systems conversions, will increase our bad debt expense by about 1% for the time being. At this point we have not reduced AmeriPath's bad debt as quickly as we had planned. However, the eventual synergy opportunity related to bad debt remains unchanged.

Diluted earnings per share from continuing operations were \$0.77 compared to \$0.82 in the prior year. The impact of the change in contract status with United has been essentially mitigated. The difference from the prior year is principally due to the AmeriPath acquisition, which will be somewhat more dilutive in the near term than initial estimates, in large part, due to higher bad debt.

Included in footnote 6 to the earnings release is a table, which summarizes the impact to various measures for a number of the items discussed.

Cash from operations for the quarter was strong at \$291 million, up sharply from Q2, and \$56 million above the prior year. During the quarter we reduced debt by \$152 million, bringing the total debt reduction since the AmeriPath acquisition to \$192 million. Cash at quarter end was \$165 million, up \$42 million from the second quarter. Capital expenditures were \$54 million in the quarter, and we repurchased \$41 million of common stock.

Days sales outstanding were 50 days, 1 day below the Q2 level, and two days above the same point last year. The increase over last year is due AmeriPath's impact on our DSOs which we expect to decrease over time.

Now, I'll turn to our full-year outlook for 2007:

Our current guidance for results from continuing operations is as follows:

- We expect revenues to approximate \$6.6 – \$6.7 billion.
- We expect operating income as a percentage of revenues to approximate 16%. This is reduced by just over half a percent due to the inclusion of AmeriPath, which currently carries lower margins than the rest of our business.

- We continue to expect cash from operations to approximate \$800 million. And we expect capital expenditures of between \$210 and \$220 million.
- And lastly, we expect diluted earnings per share, adjusted to exclude the \$0.04 in first quarter charges, to be between \$2.84 and \$2.91, the mid-point unchanged from previous guidance.
- Please note, these estimates exclude any additional special charges.

Before turning it back to Surya, one last comment on our performance:

So far, this year is best characterized as one of significant progress in the face of substantial challenges. Despite the loss of a contract with our largest private payer, and intensified pricing pressures and an increased competitive environment, we have managed to grow our business and return its underlying profitability to that of the prior year.

- We have renewed or expanded our relationships with a number of important health plans for multi-year periods.
- We've developed plans to redesign and streamline our operations for substantial savings totaling \$500 million over the next two years.
- With our recent acquisitions, we've put in place the major pieces needed to drive future growth.
- And, our focus is now on integrating and aligning the capabilities we have assembled, as we de-lever and reposition our capital structure for the next wave of growth and investment.

Now I'll turn it back to Surya.

Surya Mohapatra: Thanks, Bob.

As you have heard, we are making great progress and are well positioned to drive top and bottom line growth.

While our business has become much more competitive over the last year, diagnostic testing remains and will always represent a vital healthcare service. Our strategy based on patients, growth and people positions us well to continue to drive profitable growth.

We put patients first, with the highest standards for quality and superior service. We give patients and physicians even more reasons to choose Quest Diagnostics and we continue to differentiate ourselves competitively.

- Our patient service centers are electronically connected to the physicians' offices and our labs and are now connected to patients through electronic appointment scheduling. More than 10% of all visits to our patient service centers are now scheduled, and adoption continues to grow, with more than 50% in some locations.
- Additionally, we are piloting a portable electronic patient health record called MyCare360. It enables patients to avoid the need to fill out forms when they visit our patient service centers. Patients can also create, store, and manage their own personal health records.
- We have introduced a program called Quest Cares, in two markets to make testing available to the uninsured. This complements our existing needs-based testing

assistance program and addresses an unmet need in the market for access to healthcare services.

These actions empower patients, assist physicians and add value to health plans and employers.

We also continue to raise the bar for quality and safety through technology and Lean Six Sigma.

- We recently launched a specimen tracking initiative that enables us to accurately track irreplaceable specimens, such as biopsies, at every stage of their journey to our lab.
- We have joined the National e-Prescribing Patient Safety Initiative, a coalition of healthcare and technology companies working to drive improvements in patient care and safety.

Our growth strategy is focused on high growth, high margin products and services.

- We continue to pursue innovative new tests and technologies that improve quality and patient care. For example, volume for our Leumeta plasma-based leukemia test more than doubled compared to last year. The Leumeta family represents a suite of proprietary tests that one day may replace painful bone marrow biopsies.
- We are the leader in cancer diagnostics. Together with AmeriPath, we are able to offer a unique combination that includes routine testing, anatomic pathology and molecular diagnostics. We are in the process of aligning the two organizations to accelerate growth.
- We continue to lead the industry in advanced healthcare IT solutions. More than 120,000 doctors use Care360 for lab orders and results. We are beginning to see traction in physicians using it to write prescriptions, with more than 100,000 scripts written in September.

We are also pursuing growth opportunities outside the United States. Around the world, emerging markets are creating an educated middle class that can afford private healthcare services. We are building operations in India and we see opportunities in other countries, such as the U.K. and Ireland.

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In summary:

- We are driving top line growth;
- We continue to improve margins.
- And we are generating strong cash flow
- We are empowering patients and doctors and creating differentiated services to earn their trust and loyalty.

Within the world of healthcare, diagnostic testing is a critical tool that can detect disease early, drive treatment decisions and improve health. The opportunities are enormous, and I am excited about our future.

We will now take your questions. Operator?

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