Quest Diagnostics Incorporated
First Quarter 2004 Conference Call
April 22, 2004, 8:30 am ET

Laure Park: Thank you and good morning. I am here with Ken Freeman, chairman and chief executive officer of Quest Diagnostics, Surya Mohapatra, our president and chief operating officer, and Bob Hagemann, our chief financial officer.

Some of our commentary and answers to questions may contain forward-looking statements that are based on current expectations and involve risks and uncertainties that could cause actual results and outcomes to be materially different. Certain of these risks and uncertainties may include, but are not limited to, competitive environment, changes in government regulations, changing relationships with customers, payers, suppliers and strategic partners and other factors described in the Quest Diagnostics Incorporated 2003 Form 10-K and subsequent filings.

As a reminder before we proceed, all future revenue guidance will be provided for *total* revenues only. We will continue to report results for requisition volume and revenue per requisition each quarter. Also, as we have previously indicated, to keep everyone's focus on the longer term, after this year we will begin providing financial guidance for the full-year only – and not for each quarter.

A copy of our earnings press release, together with any information that would be required under Regulation G, and the text of our prepared remarks will be available in the "press room" section of our website later today at www.questdiagnostics.com.

Now, here is Ken Freeman.

Ken Freeman: Thank you, Laure. We had an outstanding quarter. Investments made in our selling efforts, quality and technology continue to contribute to solid growth. Here are just a few highlights before I turn it over to Bob:

- Earnings per share increased 28%.
- Revenues grew 15%, and reflect an improvement in the rate of organic volume growth.
- Margins continued to expand.
- And, as a result of strong first quarter performance, we are raising guidance for the full year.

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Turning to the CEO succession process, it has gone extremely well, and as a result of the more rapid transition of executive responsibilities, I will step down as Chairman sooner than previously planned, after the December Board meeting. After that, I will be available to provide consulting services to the company for a period of time. This will give Surya and the new management team an opportunity to be free and clear of any motivation to look backward rather than forward. As Quest Diagnostics moves to the next stage in its evolution, the company is very well positioned to grow and prosper under Surya's leadership.

Now, Bob will discuss the quarterly results and guidance, and then Surya will comment on the business. Bob?

Bob Hagemann: Thanks, Ken.

We started the year with a strong first quarter, building on the momentum we established at the end of last year.

Earnings growth was outstanding, and above our earlier guidance, fueled by strong revenue growth.

Revenues grew 14.9%, faster than we expected and above our previous guidance of 13-to-14%.

Turning to volume, the improvement in organic volume growth that we saw in the fourth quarter last year continued in the first quarter, and drove most of the favorability to our guidance.

Volume increased 11.1% for the quarter, or 2.9% on a pro forma basis, after considering the Unilab acquisition. Volume comparisons were favorably impacted by approximately 2% due to the extra day in the quarter caused by Leap Year, which was worth about a point-and-a-half, and by less severe weather this year. On our year end call, we estimated that these factors would contribute 3 percentage points of volume improvement during the quarter. The difference is due to the fact that although the impact of weather was less than last year, it was more severe than we had *anticipated*.

Revenue per requisition grew 3.1%, or 4.4% on a pro forma basis. Improvements in test mix continue to be the principal driver of the increases. Growth in gene-based and esoteric testing continued strong.

Drugs of abuse testing, which is among our lowest priced services and accounts for about 6% of our volume and 3% of revenues, showed modest growth in the quarter, the first reported growth in several years.

And, our clinical trials testing business contributed about half a point to consolidated revenue growth.

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Operating income as a percentage of revenues improved 1.7 percentage points over the prior year. The increase was driven by the improving mix of business and continuing efficiencies from our Six Sigma and standardization efforts, which have reduced both the cost of services and SG&A as a percentage of revenues. Bad debt expense, which is included in SG&A, was 4.5% of revenues, compared to 5% the year before.

Cash from operations was 111 million dollars, compared to 58 million dollars in the prior year. Remembering that the first quarter cash flow is historically our lowest due to the timing of several large payments, this was excellent performance. Days sales outstanding were reduced by 3 days during the quarter to 45 days.

During the quarter we paid dividends totaling 15.4 million dollars and repurchased 547 thousand shares for 45 million dollars at an average price of 82 dollars per share. We have now repurchased a total of 4.5 million shares at an average price of approximately 67 dollars per share since initiating our repurchase program last May. We have now utilized approximately half of the 600 million dollars of share repurchase authorization made by the board.

Earlier this week we completed a refinancing of our bank term loan and credit facility, and our accounts receivable credit facility, to take advantage of the improved lending environment and our improved credit profile. The new 500 million-dollar bank facility runs for five years and the new 300 million dollar accounts receivable facility runs for three years. We plan to use these facilities to retire the 230 million dollar term loan we have outstanding. As a result, we expect to reduce interest expense for the remainder of the year by approximately 1.7 million dollars. However, we will also record a non-cash charge of 3 million dollars in the second quarter associated with the write-off of deferred financing costs on the old bank facility and term loan.

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In addition, in connection with the accelerated CEO transition, certain pension obligations have been accelerated and are being expensed over a shorter service period. This change is expected to result in charges during the remainder of the year preliminarily estimated to total 8.6 million dollars, or 5 cents per share, which were not anticipated in earlier earnings guidance.

It is important to note that these charges, and the refinancing charge are discrete items. These are not ongoing costs of doing business. Our business is performing well and we are confident in our ability to generate continued gains in revenue, productivity and earnings.

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Turning to our outlook, we expect 2004 to be another year of solid performance improvement, and we are increasing guidance.

Starting with full year guidance -- as a result of our strong first quarter performance, we are increasing our estimate for total company revenue growth from 6% to 7%. The estimated impact of including a full twelve months of revenues from Unilab remains about one-and-one-half percent to reported revenues.

Full year earnings per diluted share are expected to increase to between $4.80 and $4.90, before charges associated with the accelerated CEO succession and the refinancing activities. This compares to earlier guidance for EPS of $4.70 to $4.80, which also excluded such charges. A reconciliation of the EPS guidance with and without the charges is included in the earnings release in footnote 5. We now expect cash from operations to approximate 700 million dollars, operating income as a percentage of revenues to approximate 18% and capital expenditures to be between 180 and 190 million dollars.

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For the second quarter, we expect revenues to grow approximately 5%. This rate represents our estimated organic rate of growth, now that we have anniversaried the Unilab acquisition this past quarter. Operating income as a percentage of revenues is expected to exceed 18%, and earnings per diluted share is expected to be between $1.25 and $1.30. These estimates exclude charges preliminarily estimated to total approximately 6 million dollars or 4 cents per share related to the accelerated CEO succession and the refinancing activities.

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Now, I'll turn it over to Surya.

Surya Mohapatra: Thanks, Bob.

As you heard from Ken and Bob, 2004 is off to a great start. We are encouraged by continuing progress in driving improved performance.

A major focus for the past year has been on improving organic growth, and we have shown sequential progress over several quarters. As I tell our employees, there are only a few ways to grow organically: you have to work hard to keep your existing customers and sell them additional services; find new customers; develop new products; and expand into new geographies. We are making progress in each of these areas.

We are investing in our sales force. We are adding sales staff and providing enhanced training to our segmented sales organization to focus on the special requirements of different customer groups. *And,* it is producing results. Our hospital sales team is making progress. We are growing hospital revenues by attracting new customers and expanding and improving services to existing customers. Our value proposition to hospitals is unmatched, with full-service esoteric testing laboratories on both coasts geared specifically to meet the needs of hospitals.

At the same time, investments in Six Sigma are driving improvements in service, customer loyalty and efficiency. Quality and consistent service are important ways that we differentiate ourselves from the competition. We are taking Six Sigma to the next level with Lean Six Sigma. Lean reduces waste and unnecessary steps. We are using it to streamline specimen processing and to design more productive lab facilities. Six Sigma enhances quality. Lean enhances speed.

We continue to invest in medical science and information technology to strengthen our competitive advantage.

Growth in gene-based tests continues to outpace the rest of the business, and we have many fast-growing tests that are not gene-based. For example, we are benefiting from heightened interest in cardiovascular testing overall, from routine HDL and LDL cholesterol testing to Cardio CRP to esoteric tests such as cholesterol subparticle analysis.

Additionally, we are experiencing growth from the HPV DNA cervical cancer screening test, ImmunoCAP allergy test and the Insure colorectal cancer screening test. We continue to educate physicians on the benefits of these tests, enabling them to make better-informed decisions for their patients.

With regard to the new OvaCheck ovarian cancer blood test from Correlogic, we are evaluating data from the validation studies. Our goal is to launch OvaCheck later this year.

A unique differentiator as we move forward is our growing expertise in healthcare information technology. Quest Diagnostics' healthcare IT solutions improve efficiency and reduce opportunity for errors in lab ordering and drug prescribing. Our patient-centric physician portal, eMaxx, allows doctors to aggregate and share patients' healthcare records in a completely secure, HIPAA-compliant way. This enables doctors to spend more time with patients, enhancing the quality of care.

In the past few months, we have established some of the initial relationships that will help to make e-prescribing a reality for our physicians. New relationships with Medco Health Solutions, SureScripts and RxHub, will assist us to provide doctors with enhanced electronic prescribing capabilities.

We continue to see rapid growth in the use of our Internet-based services. By the end of the first quarter, we were receiving 30% of test orders online and were delivering around 40% of test results via the Internet.

Now, turning to geographic expansion, in North Carolina and Ohio, we are seeing progress. We have invested in infrastructure in these markets where we have historically lacked a significant presence. We are winning business because customers appreciate having a choice and recognize the benefits of our powerful value proposition that is based on four pillars -- Six Sigma quality, unparalleled access and convenience, innovative science and medicine, and advanced IT solutions.

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We have the strategy, the resources and motivated people to continue to drive exceptional performance.

Now I'd like to turn it back to Ken.

Ken Freeman: Thanks, Surya.

Putting it all together:

- We had a strong first quarter.
- Based on the better-than-expected performance, we are raising guidance for the full year.
- And, our efforts to improve the rate of organic revenue growth are paying off - - we are seeing tangible signs of progress.

Quest Diagnostics has become a strong company, and I am proud to have played a part in its success. I am also very proud to be turning over the leadership of our company to Surya at the annual stockholders' meeting in May, and Quest Diagnostics has a great future.

And, as a result of our compelling value proposition and the investments we have made and will continue to make, Quest Diagnostics is well positioned to continue providing superior returns for shareholders.

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