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Questioning Market Leaders For Long Term Investors

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**THE WALL STREET TRANSCRIPT**

## COMPANY INTERVIEW

# KENNETH W. FREEMAN

## Quest Diagnostics Incorporated



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COMPANY INTERVIEW

# Quest Diagnostics Incorporated (DGX)

**KENNETH W. FREEMAN** is Chairman and CEO of Quest Diagnostics Incorporated. Mr. Freeman began his career in 1972 as an Internal Auditor at Corning Incorporated. For the next 15 years he progressed through Corning's financial function. He was elected Vice President and Corporate Controller in 1985, and named Senior Vice President in 1987. Mr. Freeman was appointed General Manager of the Science Products Division in 1989, and President and CEO of Corning Asahi Video Products Company in 1990. In 1993, he was appointed Executive Vice President of Corning Incorporated. In May 1995, Mr. Freeman was appointed President and CEO of Corning Clinical Laboratories. In January 1997, when the business was spun-off to Corning's shareholders as Quest Diagnostics Incorporated, he was appointed Chairman, President and CEO. Mr. Freeman holds a Bachelor of Science degree from Bucknell University and an MBA degree from Harvard University. He is a member of the Board of Directors of TRW, Inc., and the American Clinical Laboratory Association, and a trustee of Bucknell University.

**SECTOR – MEDICAL LABORATORIES & RESEARCH**

**(NAH357) TWST: What's gone on at Quest Diagnostics over the last year or so that investors should focus on?**

**Mr. Freeman:** We've come a long way in the last year. As you know, we acquired one of our largest competitors, SmithKline Beecham Clinical Laboratories, in August 1999. Since that time, we've been integrating two roughly equivalently sized companies to create the industry leader for diagnostic testing, information and services.

We have delivered breakout performance — roughly doubling net income in 2000. This year, we're on track to improve our earnings per share by at least 60%. That's a pretty good track record during a time of complex integration. In fact, we defied history in our industry by successfully integrating two large companies while at the same time driving exceptional top and bottom line growth.

**TWST: In terms of the acquisition, how has the integration gone relative to what you expected?**

**Mr. Freeman**: We're very much on track. We made a commitment to the Street initially that we would achieve at least $100 million of annual synergies as a result of bringing the two companies together. We increased our commitment to the Street about a year ago to be $150 million, and we're firmly on track. We fully expect to be at the $150 million annual run rate as we go through the year 2002.

**TWST: Where have those savings been achieved?**

**Mr. Freeman:** They've been achieved across several different areas, including the consolidation of testing facilities around the country.

We went from 40 major laboratories to 30 major laboratories without exiting any geographic markets in terms of market presence.

In addition, we're achieving integration benefits from billing as we're driving the bad debt associated with the SBCL business to levels that we achieved historically in the old Quest Diagnostics. At this point, we're at 6.1% bad debt as a percent of sales at the end of quarter 2, and we're continuing to drive our bad debt rates lower, toward our longer term goal of 4%. Back in 1999, on a pro forma basis, bad debt was 7.6% across the entire company.

A third area of emphasis for us relates to infrastructure and purchasing as we've removed duplication of efforts in areas like our patient service center locations and national logistics network. Also, as the largest buyer in our sector, we have an opportunity to take advantage of our scale.

**TWST: Have there been any downside surprises in the combination yet?**

**Mr. Freeman**: Not to my knowledge. However, it certainly has been very challenging! We have grown our revenues during a period of integrating two major companies. This is a first in the history of our industry bringing large companies together. In the year 2000, our revenues grew 9%, even as we were increasing our prices and bringing two highly complicated companies together, and removing 25% of our operating capacity by going from 40 to 30 major labs.

We're very proud of our progress to date. But what's most important, of course, is how our customers and employees feel about it, and they're in the game with us.

**TWST: Do they think everything is going along well from their perspective?**

**Mr. Freeman:** Customers are all unique, having their own slightly different points of view, as you know. Overall, we're making good progress, our customer satisfaction metrics are improving and have been improving as we have gone through the integration process. In addition, our employees, who represent the front line for our relationships with our customers, have done an incredible job transitioning responsibilities and processes during the integration.

**TWST: As we look out from here, what's the strategy now?**

**Mr. Freeman**: Our focus is on building further upon our industry leadership position. Today, we are the leading provider of diagnostic testing information and services. We're the number one player in all major segments of diagnostic testing, whether it be routine testing, substance abuse testing, anatomic pathology testing outside of hospitals, and in particular, esoteric testing and gene-based testing where we're the clear number one leader in this country — in fact, in the world. And that's a wonderful platform from which we intend to grow.

Our intent over time is to be known as the "gold standard" for quality in health care, and the undisputed leader in providing health care insights to the more than 100 million patients who depend on us every year.

From a financial standpoint, our strategy is crystal clear. We call it "10, 20, 30, and Investment Grade." Our goal is to generate top line growth at a sustainable rate of 10% a year. We're moving toward that point as we speak. Top line growth will be fueled by a combination of organic growth and selective acquisitions. We generate very strong cash flows, which will be used to take advantage of strategic acquisitions in an industry that remains highly fragmented, as well as to further improve our balance sheet by repaying debt. Last year and this year we will generate more than $250 million of free cash flow.

The "20" is 20%-plus EBITDA margins. We intend to continue to grow our EBITDA margins coming off of tremendous improvement over the last few years, and we intend to sustain that momentum moving forward. In 1999, our pro forma EBITDA was around 10%. In the year 2000, we improved our EBITDA margins to over 13%. This year our EBITDA margins will be a bit more than 15%. And over the next few years, we intend to get to the 20% level and beyond.

The EBITDA improvement has been driven by revenue growth and integration savings that I mentioned earlier, but we're also now moving to derive benefits from standardization of processes across the company and to capitalize on the power of Six Sigma quality. Six Sigma is a major quality initiative underway in our company with significant investment at this point, as we train and deploy Six Sigma experts. We expect to yield positive net benefits starting in 2002. We're borrowing Six Sigma from the world of manufacturing, to deploy the best available techniques to improve processes for the benefit of customers, and at the same time eliminate waste in terms of unnecessary steps and costs.

The "30" is driving continued earnings per share growth of at least 30% a year. We've been achieving that performance over the past few years and we see the way to continue to drive EPS improvement of at least 30% for the next several years. Standardization and Six Sigma, and top-line performance through volume growth, continuing price discipline, and selective acquisitions, are the drivers as we look ahead.

Investment-grade credit statistics are also very important to us. We generate strong cash flows. For example, from the time we acquired SmithKline Beecham Clinical Laboratories to this day, we've repaid a tremendous amount of debt. Over $300 million of debt has been repaid since the acquisition. Standard & Poor's upgraded us to investment grade status earlier this year. And we're on positive credit watch from Moody's currently.

Investment grade credit ratings provide enhanced financial flexibility to be opportunistic with respect to strategic initiatives. In addition, continuing to pay down debt is another driver of earnings improvement, and will help us sustain the 30%+ a year improvement in EPS.

In June, we refinanced the majority of our debt on significantly improved terms, replacing our high yield debt with long-term commercial debt, as well as completely refinancing our bank debt to improve financial flexibility and take advantage of our investment grade credit rating. The refinancing created annual savings of approximately $23 million pre-tax.

**TWST: Where does the bulk of the additional improvement in operating margin come from?**

**Mr. Freeman:** There are several areas to keep in mind. First, consider those things that we are doing internally. They are the things we know we can control, even in a challenging economic environment, although our business is very much economy-resilient given that we provide an essential healthcare service. So let's start with integration, standardization and Six Sigma.

Keep in mind that we have a bit more integration savings to realize of the $150 million annual savings commitment. We've also made a commitment that we're going to achieve at least $150 million of additional savings through standardization and Six Sigma improvements which we expect to realize over the course of the next several years, between now and the end of the year 2004.

These are internally driven opportunities that, coupled with lower interest costs as a result of the refinancing, and our ability to continue to pay down debt, will help us continue to provide strong improvement in earnings.

The most important driver, of course, is top-line growth. This will result from our continued steadfast commitment to appropriate pricing discipline, restoring organic volume growth to rates higher than the industry average, and putting our strong cash flows to work via selective acquisitions. As you know, during an integration period, you're focused most heavily on maintaining your existing customer base, particularly when you're adjusting capacity and and processes. We're past that stage now and have recently refocused our sales force from retaining business during the past two years to now being on the offensive, aggressively pursuing new growth opportunities.

Our value proposition is unique in the industry. We offer the broadest access to laboratory testing in the country for physicians, patients and employers. We offer the broadest menu of tests. We are the first public company in health care services to pursue Six Sigma quality. We offer unparalleled capabilities relating to technology, as we introduce over 100 new tests a year to the marketplace. We are the leaders in the rapidly growing areas of gene-based testing and esoteric testing, through Nichols Institute, our world-renowned center for innovation on the West Coast.

**TWST: As you look at the industry, what are the trends that are going to drive business over the next couple of years?**

**Mr. Freeman:** First, it is important to establish that what we do is vital to patient care. We impact over 70% of health care's decisions even though we're a relatively small part of the health care dollar. In addition, demographics strongly favor our industry. The population is aging, and it is also growing, both of which drive additional demand for testing. As individuals take more and more care of their own health and assert their role as consumers of health car services, we believe that's an important driver to help drive future growth for us as well.

Technology and e-commerce are changing what we do and how we do it. Gene-based testing in particular is an explosive area of growth, growing, for us, at around 25% a year or so. Last year we had over $225 million revenue from gene based testing, and this segment of the business is still in its infancy!

Genomics and proteomics, the ability to use information about genes and proteins to help not only diagnose and even predict disease but also to improve the ability of a doctor to predict the effectiveness of treatment is the biggest breakthrough to impact our business in many years. Gene-based tests and proteomics-based tests are becoming more commonly associated with medical treatments, and they are becoming what the future of health care is going to be all about.

An additional trend in our business is the continuing consolidation of the diagnostic testing industry. Even though we are the industry leader today with about 10% of the overall revenues derived from lab testing in this country, there are around 5,000 independent clinical laboratories, in communities across the country. Our ability to generate strong cash flows provides us the opportunity to continue consolidating our industry to the benefit of patients, physicians, payers and other providers. Through the successful integration of SBCL, we have demonstrated an ability to complete timely acquisitions and bring them into the fold without disrupting our customers, while at the same driving top and bottom line growth.

**TWST: Is there anything else on the horizon that's going to provide some added impetus to the business?**

**Mr. Freeman:** Certainly genomics and proteomics are very important, as is esoteric or highly specialized testing in general. These are very important drivers for growth as we move forward. In addition, we should consider the fact that going direct to consumers with health care services, including laboratory test results, is in its early, early days. Consumerism is alive and well in this country. It's coming to health care, much the way it changed financial services a decade or so ago. As the baby boomers continue to change society, they are beginning to have an impact on health care. And since lab tests are so important to the diagnosis and prevention of disease, more and more people, we believe, are going to avail themselves of going direct to laboratories for that knowledge.

In addition, the ability to provide much more robust information technology capabilities to our physician and hospital customers is very important and will become an ever more important fuel for growth. We're just about to close the acquisition of a company called MedPlus, which has developed strong capabilities to provide hospital information technology solutions in terms of electronic medical records. These are not just traditional CPU to CPU based capabilities but Internet-based capabilities to drive the confidential, personal electronic medical record. The MedPlus products, called Chart Maxx and E Maxx, are fully HIPAA compliant today, and when combined with our diagnostic testing capabilities, represent a comprehensive solution for hospitals and physician groups.

**TWST: So that's coming to a hospital near you?**

**Mr. Freeman**: Absolutely.

**TWST: You mentioned acquisitions. You've certainly made a big one and now this one for medical records. What else are you looking for that you need to complete your portfolio?**

**Mr. Freeman**: Keep in mind that we have a highly selective approach to making acquisitions. Our ground rules are well known — compliance with the law, well run, and accretive to earnings. We constantly evaluate opportunities in the areas of esoteric testing and gene based testing, as well as opportunities to help improve our market access and our leading position in terms of breadth of offering and access around the country.

We also consider opportunities that can bring new technology capabilities to our company. The acquisition of MedPlus is an example of a technology capability coming to us through acquisition, to drive speed to market, rather than taking the time to build the capability ourselves.

**TWST: As we look ahead, we see the drum beat on "cost containment" continue. What impact will that have on you as we look forward?**

**Mr. Freeman:** Certainly, Medicare and Medicaid are important customers of ours today, and we are sensitive to the broader need for cost containment. In general, our price increases have been far below the average level of health care inflation in this country. As the industry leader, we have worked very hard to build an atmosphere of trust with the regulators at both the federal and state government levels. While we have made good progress, and we do feel that there's a willingness to listen, we do expect that the reimbursement environment will remain challenging.

**TWST: So the educational process is beginning to work?**

**Mr. Freeman**: Slowly, but surely. The value that diagnostic testing provides in the health care equation is better understood today. There is pending legislation in Congress to reinstate the CPI adjustment in terms of reimbursement, and to speed the process for determining appropriate reimbursement for new tests and technologies. We continue to work with Washington in a very collaborative way.

**TWST: Do you have the management team in place to support what you want to do?**

**Mr. Freeman:** I believe we do. We have a tremendous team at Quest Diagnostics. We have 27,000 employee shareholders who are dedicated to our vision and values, striving to meet the needs of our customers every day. The management team is made up of talented people that have grown up within health care, and outside of health care. We are supplementing the tremendous expertise within our company with additional talent from companies like General Electric, Allied Signal, Citibank and Procter and Gamble to keep us at the cutting edge of driving productive change.

**TWST: As you've made this major acquisition and melded these companies together, what did that do to the corporate culture?**

**Mr. Freeman:** Our corporate culture has become stronger. The values that define a corporation's culture were more similar than different at the two former companies. And, our employees originated from companies that had long-standing cultures with rich traditions: Corning Incorporated and SmithKline Beecham, now GlaxoSmithKline.

Having been part of fairly large companies previously and having been, in a way, cast-offs from those two companies, all of us were united in a common desire when Quest Diagnostics and SBCL came together. We were on a mission to demonstrate our capability and prove to each other and to the world that we could be very, very effective in what we do, and create outstanding value for our shareholders.

Our people are very talented, and they're very committed. The culture is one of focusing on our customers, our employees, and our shareholders. We believe that with satisfied employees, customers will be satisfied. And with satisfied customers, the shareholders will be rewarded. And of course, our employees are all shareholders as well. So it is a complete circle that works quite nicely.

Culturally, we've made tremendous strides. As you would expect any time you bring large companies together, it's a never-ending process. Any company, even without acquisitions, must continually evolve its culture or get left behind.

We strive very aggressively to embrace change. So the culture tomorrow is going to be a bit different than it is today and a bit different than it was the day before, but all grounded in what we call our corporate values, the bedrock for being a well-known, highly respected company with outstanding performance.

**TWST: You said earlier that you're really not very sensitive to the general state of the economy. If that's not a risk, is there some risk out there that we should be aware of?**

**Mr. Freeman:** Certainly we're more resilient to the effects of an economic slowdown than many other segments of the United States economy. In general, we feel very little impact from economic ups and downs. We provide an essential healthcare service that drives more than 70% of healthcare decisions, so our services are needed equally in good economic times and bad.

One segment of our business, drugs of abuse testing, is directly impacted by the economy, and is a very small part of our company. It represents about 6% of our revenues and 10% of our specimen volume, and through the first half volume declined about 20% due to reductions in hiring and fewer employees in the workplace than there were previously. So that business felt a significant downdraft, but represents a small part of our business.

With respect to other risks we face, at the top of the list is intense competition. We participate in a highly competitive industry today, and that's what makes the world of business very challenging.

A second risk is execution of standardization. We know what to do as we deploy common systems and processes across the company. We've done it before and we will do it again. But certainly I think it's appropriate for us to consider this as a risk because that ensures we're laser-focused on making sure it's done successfully.

**TWST: Do you think the market is fairly valuing Quest Diagnostics today?**

**Mr. Freeman:** We don't generally comment on our stock price, but we do feel strongly that people may not fully appreciate how well positioned we are to achieve continued growth and generate strong cash flows.

As the industry leader, as the company setting the tone for this vital segment of health care services, we think we're ideally positioned to create substantial shareholder value.

**TWST: Why is the market not catching that?**

**Mr. Freeman:** I don't know. The overall market has been volatile in recent months, reflecting concerns about the economy. One of the key things that investors sometimes don't understand is the fact that about $0.40 on a fully diluted basis gets charged to our P&L as a result of amortization of intangibles. I think that's very important to note. It's a non-cash charge, and it makes more sense to look at the earnings power of our business when you add that back.

**TWST: If you were sitting down today with some potential longer-term investors, what are the two or three reasons you'd give them to take a look at your stock?**

**Mr. Freeman:** Start with the fact that we are the industry leader, in an industry with favorable trends, and we're a company with significant growth opportunities. We have a proven capability to grow, organically and through selective acquisitions. We have a strong track record for doing what we say we will do. Our earnings per share have improved for eighteen consecutive quarters. We generate tremendous cash flows, which allows us to continue deleveraging and to take advantage of investment opportunities. We're a company that is building on our industry leadership position by providing unparalleled access, and unparalleled innovation. In the end, unparalleled quality and service, the outcome of our Six Sigma initiative, is the ultimate differentiator that will fuel bottom line and top line growth and at the same time yield outstanding results for our employees, customers and shareholders.

**TWST: Thank you. (TM)**

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