**FINANCIAL STATISTICS**

**Price:** $82.87 (as of February 27, 2004)

- Symbol | Exchange: DGX | NYSE
- 52-Week Range: $50.00 - $85.87
- Market Cap: $8.52 billion
- Shares Outstanding: 102.8 million
- Relative P/E: 0.84
- Trailing P/E: 20.14 (Stock) vs. 20.93 (Industry)
- PEG Ratio: 1.15 (Stock) vs. 1.07 (Industry)
- ROA: 18.2%
- ROE: 18.5%
- Total Debt/Equity: 0.46
- Current Ratio: 1.376
- Annual Dividend: 0.60
- Dividend Yield: 0.73%

**Intrinsic Value:** $86.98

**COMPANY PROFILE**

DGX is a nationwide clinical laboratory testing company in the detection, diagnosis, monitoring and treatment of diseases providing for physicians, hospitals, managed care organizations, employers, governmental institutions and other independent clinical laboratories. Quest’s internal growth has been prominent in four main areas: gene-based and other esoteric tests1, anatomic pathology, selective regional acquisitions, and connectivity solutions. Under anatomic pathology, one of their strengths lies in cytology. They led the industry in converting approximately 80% of their pap smear business to the use of monolayer technology (a more profitable and higher quality technology) in cervical cancer screening. In regards to its future, Quest will continue their expansion plan in order to reduce their current costs and improve efficiencies (elimination of redundant facilities, equipment, and personnel). Additionally, demands for connectivity solutions have been increasing, and Quest has launched eMaxx \(^\text{TM}\) for the purpose of making access to laboratory tests easier for ordering and reviewing as well as keeping patient-centric information safe.

**Strategic growth strategies.** Quest’s internal growth has been prominent in four main areas: gene-based and other esoteric tests\(^1\), anatomic pathology, selective regional acquisitions, and connectivity solutions. Under anatomic pathology, one of their strengths lies in cytology. They led the industry in converting approximately 80% of their pap smear business to the use of monolayer technology (a more profitable and higher quality technology) in cervical cancer screening. In regards to its future, Quest will continue their expansion plan in order to reduce their current costs and improve efficiencies (elimination of redundant facilities, equipment, and personnel). Additionally, demands for connectivity solutions have been increasing, and Quest has launched eMaxx \(^\text{TM}\) for the purpose of making access to laboratory tests easier for ordering and reviewing as well as keeping patient-centric information safe.

**Industry revenue growth of 5% to 7% per year.** Clinical laboratory testing is an essential element in the delivery of healthcare services. In 2002, the US diagnostics testing industry had over $36 billion in annual revenues. Although the industry will grow at a slow rate, Quest will achieve more profitability. Yet given this revenue projection, DGX can potentially surpass this baseline (given a three-year average, historical revenue growth of 11%), based on the following factors:

- General expansion and aging of US population
- Increasing recognition of the importance in role of clinical lab testing in healthcare – drives more than 70% of healthcare decisions
- Continued robust development of new tests, such as CF-complete™ (the only cystic fibrosis test that sequences the entire gene) and cervical cancer screening
- Continuing R&D in the area of genomics and proteomics, which is expected to yield new genetic tests and techniques
- Strong penetration and growth in the esoteric test market, which revenues approached $400 million for the year, growing at more 20% compared with prior year
- Increasing volume of tests for diagnosis and monitoring of infectious diseases such as AIDS and Hepatitis C
- Advances in connectivity with its customers, such as eMaxx \(^\text{TM}\) – Quest’s internet portal
- Debt refinancings as well as share repurchases (near $258 million) adding visibility onto their EPS (approximately 15% projected growth)
- Medicare: a co-pay proposal dumped in favor of a basket freeze on the lab fee schedule
- Clean integration with Unilab, American Medical Laboratories and other acquisitions, which allows DGX to receive nearly $25 to $30 million and 15 million in annual synergies, respectively.

\(^1\)Esoteric tests are generally in the following fields: endocrinology, genetics, immunology, microbiology, oncology, serology, special chemistry, and toxicology.
RISK ANALYSIS

Increase in consolidation. Due to their large service networks and lower cost structures, large independent clinical laboratories may increase their overall market share through acquisitions.

Quest’s information systems may incur sustained or repeated system failures. As a result, Quest may not be able to process test orders, deliver test results, or perform tests in a timely manner. Thus, their reputation, amount of customers, and net revenues are on the line. However, Quest has confidently assured reliability and maintainability in their systems through Six Sigma initiatives and standardization.

Possible expenditure increases in sales and marketing, information technology, and customer incentives. In pursuit of these expenditures, Quest will obtain customer satisfaction, loyalty and new business wins.

Incur significant additional costs as a result of their participation in Medicare and Medicaid programs. Billing and reimbursement for clinical laboratory testing are subject to considerable and complex federal and state regulations. If the co-insurance proposal had been enacted, Quest’s revenues as well as revenues of other clinical laboratories would have a negative effect by exposing the testing laboratories to the credit of individuals and by increasing the number of bills. However, Quest expects overall reimbursement dynamics for all payers on a combined basis to move from neutral to positive for laboratory testing industry. Also, their investment in information systems will allow them to manage billing processes much more easily.

Potential increases in bad debt expense. Accounting for 5.3% of net revenues, bad debt expense is primarily the result of missing or incorrect billing information received from healthcare providers. However, Quest achieved reduction in bad debt expense to 4% by incorporating Six Sigma initiatives and will continue further reduction.

Vulnerable to the health of the US economy. An unstable economic environment, such as a continued loss of jobs, would negatively impact the volume growth of testing per requisition. For instance, testing drugs of abuse services for employers (accounting for nearly 4% of DGX’s net revenues), declined significantly during 2001 and 2002 driven by a slow economy and a corresponding slowdown in hiring. With routine testing growth susceptible to economic pressures, US clinical laboratories have craved for growth in esoteric testing markets.

Seasonal fluctuations may impact testing volumes. During the summer months, year-end holidays periods and other major holidays, testing volume typically declines. Therefore, net revenues and operating cash flows fall below annual averages. Depending on severity of inclement weather in the winter months, testing volume may also decline.

Possible increases in federal and state regulation. US clinical laboratories must comply with federal and state regulation, including inspections and audits by governmental agencies. For example, typical regulatory bodies include the Clinical Laboratory Improvement Amendment of 1988 (CLIA); Substance Abuse and Mental Health Services Administration (SAMHSA) for drug testing; Drug Enforcement Administration (DEA) for controlled substances; Food and Drug Administration (FDA) for instruments, test kits, reagents, and other devices; Occupational Safety and Health Administration (OSHA) for workplace safety; the Dept. of Transportation, Public Health Service, US Postal Service and the International Civil Aviation Organization for specimen transportation. Any future legislation may consequently impact revenues and growth of US clinical laboratories. Thus, compliance with all government rules and regulations has become a main concern throughout the diagnostic testing industry because of evolving interpretations of regulations and national debate over healthcare.

Potential rapid growth of Managed Care Organizations (MCOs). As a result of the need to reduce overall healthcare costs and excess laboratory testing, industry consolidation of MCOs have led to revenue and profit declines across the diagnostics testing industry. With MCOs achieving economies of scale, they have significant bargaining power in negotiating fee arrangements with healthcare providers. MCOs demand that clinical laboratory service providers accept discounted fee structures. Specifically, clinical laboratories receive a fixed monthly fee for each individual enrolled with an MCO and for all laboratory tests performed during the month regardless on the number of tests actually performed. However, since 1999, a slump in the growth of managed care and their declining bargaining power has contributed to a renewed growth in diagnostic testing volumes and further improvements in profitability. Also, MCOs have begun to offer more freedom of choice for physicians and for which laboratory to use and which tests to order. Patients are also given more freedom on selecting plans, such as Preferred Provider Organization (PPO). If, in the future, Quest cannot agree on pricing with a MCO, DGX will become a “non-participating” provider, leading to a significant loss of business. The loss of multiple major MCO agreements could have a materially adverse effect on Quest’s financial condition, operations, and cash flow.

KEY FACTS

- Market Leader (overall $36 billion industry)
- Market Leader in $400 million esoteric testing revenue
- Market Leader in all segments of the market:
  - routine (total $26 billion, growing 1-2% annually)
  - esoteric (total $4 billion, growing 10-15% annually)
  - anatomic pathology (total $6 billion, growing 10% annually)
  - drugs of abuse (total $1 billion, declining by 10% annually)
- Estimated 12% market share (20% for other independent labs, 8% for physician labs, and 60% with hospitals)