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'Quest' and ye shall find

There ought to be deflation, these pages have long contended. As the cost of making things falls, so should the price of buying them. Actually, "deflation" is not quite the word. For the wholesome dwindling in the average level of prices in a time of technological wonder, an observant layman might say "progress" instead.

Which brings us to Quest Diagnostics Inc. (DGX on the Big Board). Quest is the biggest American medical lab testing company. It serves 50% of the nation's hospitals. It serves—each and every year—one-third of the American population. In the past decade, it has processed over 20 billion test results. In performing these prodigies, Quest serves as a case study in scientific and industrial progress. The tests it performs are getting cheaper and the margins it thereby earns are getting thinner. As for competition—thanks in part to federal regulation—it's becoming more ferocious. To anticipate the analytical conclusion, we are bearish on Quest, bullish on ingenuity.

Possibly, you yourself have dropped into one of Quest's 2,200 service centers to deposit a sample of something or other. If so, that sample was borne off to one of the company's more than two-dozen major testing sites by one of the company's 3,500 couriers. Results were conveyed to the appropriate doctors the following day.

In 2013, Quest derived 54% of revenues from routine tests like lipid profiles, 35% from gene-based, esoteric and anatomic pathology tests and 3% from drug tests. It earned 8% of revenue from non-testing services that include healthcare information technology and running clinical trials for pharmaceutical companies.

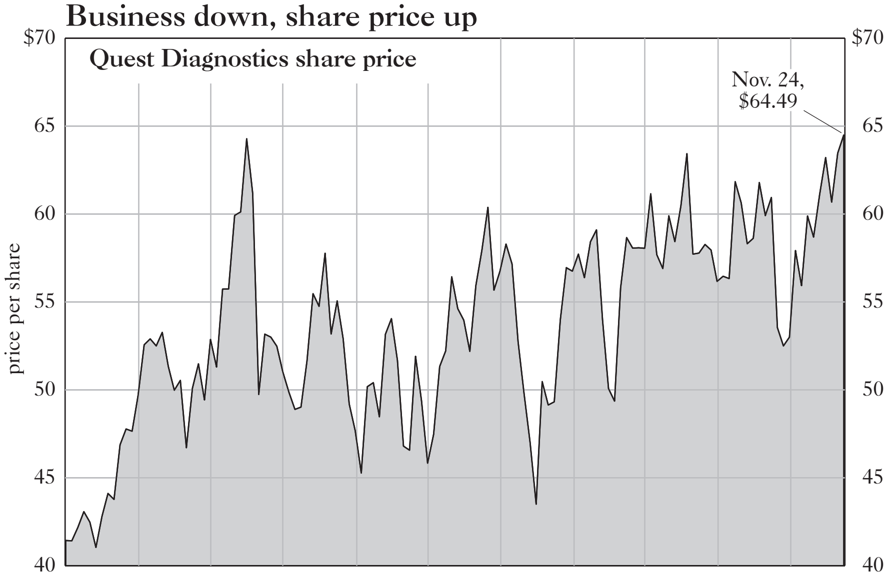
The American lab market is a $75 billion market, Quest estimates, though it's not all up for grabs. Hospitals, and hospital-owned physician practices, own $50 billion of it. Of what remains, Quest and Laboratory Corp. of America Holdings (LH on the NYSE) command 26% and 20%, respectively.

Quest's revenue per test fell by 3.6% in 2013 and by 1%, measured year-over-year, in the third quarter of 2014. It's an anomaly, Brian Tanquilut, the Jefferies analyst who covers DGX and LH, remarks to colleague Evan Lorenz. "What is interesting to me," says Tanquilut, "is you have two very big players here, Quest and Lab Corp., and yet it is a very price-competitive and price-sensitive market. In most businesses where you have—I don't want to say a duopoly—but you have a very limited number of dominant players on a national scale, you usually don't see this kind of pricing pressure. But the payers (i.e., insurance companies and the Centers for Medicare and Medicaid Services) still think there is room to squeeze and that this is a commodity business. It is very competitive."

All the more so under the Affordable Care Act. The law gives doctors and hospitals a financial incentive to consolidate through so-called Accountable Care Organizations. In 2002, hospitals owned just over 20% of physician practices; today, they claim about three-quarters of them.

Post-ACA, hospitals find it expedient to bring testing in-house. "For a hospital it is a fixed-cost business, and if you can run more tests through that hospital-based lab then you make more money," Tanquilut says. "That's the difference between a money-losing lab operation

Business down, share price up



source: The Bloomberg

and a profitable lab operation for a hospital, especially if you are a larger hospital system where you have multiple facilities or you have a large 250-to-500-bed or even larger kind of hospital. Quest and Lab Corp. are both losing share to the hospitals for that reason."

Gone are the days when, to many employed Americans, health care seemed as if it were free. "The out-of-pocket component has gone up and that has worked in a way—I don't want to say dissuade people from using healthcare—but to be more judicious in how they use healthcare services," Tanquilut proceeds. "I always give this as an example: when I started working here at Jefferies, it was a $5 copay to go to the doctor. Every time I had a cold, I was at the doctor's office. Now it is like $40 and I think twice. I will go to CVS instead and get some Nyquil or Dayquil."

Quest's organic volumes—that is, volumes before acquisitions—have been shrinking. Some of the decline is management-induced; the company says it wants to eliminate marginal business. "We already give a great value, we don't feel the need to continue to reduce price, despite what our customers might desire, because we're already giving you excellent value and any decision you made is going to have ramifications in other places because it's a transparent world," Quest CFO Mark J. Guinan told a Morgan Stanley healthcare conference in September.

Quest's competitors seem not to be inclined to take such a high-minded competitive position. "Lab Corp. has been very aggressive on pricing," a short-seller of Quest's shares (he asks to go nameless) tells Lorenz. "Quest, and this is a new narrative that they are talking about, said they won't compete on price. They are trying to hold the margin line. But they will lose share. Their hope is that others lose share faster." Not so far: In the September quarter, Lab Corp.'s volumes showed year-over-year growth, mainly organic, of 6.9%.

Quest has responded to weak pricing and sluggish volumes by attacking costs. Upon taking the helm in May 2012, the current CEO, Stephen H. Rusckowski, promised $500 million's worth of cost cutting. He subsequently upped the ante to projected annual savings of $700 million. And just the other day, he loaded on another $600 million's worth of promised future reductions. You'll see the results by the end of 2017, he said.

You haven't seen them yet. In 2011, Quest posted a 13.4% operating margin. It followed with margins of 16.3% in 2012, 14% in 2013 and 13.4% in the third quarter of 2014. "They have harvested a lot of the low-hanging fruit," Tanquilut says. "One criticism that Quest gets is they give you a big number on their cost-cutting initiatives, but the net number is not as big because they are coming in merely to offset labor inflation. If they are giving you a $1.2 billion number on cost saves, the real impact to the P&L is much lower."

Acquisitions explain why Quest's revenues have not only not fallen, but have actually registered a 6.5% jump in the just-ended quarter; since 2011, management has bought $2.3 billion's worth of businesses, mostly test companies. The acquirer's balance sheet seems none the worse for wear; at last report, debt totaled 2.9 times trailing EBITDA (earnings before interest, taxes, depreciation and amortization). Operating income covered interest expense by a factor of more than six. Quest's public debt is rated triple-B-plus, at the low end of investment grade.

"Interesting to note," Lorenz observes, "Lab Corp., though it appears to be capturing market share, has not placed so great a focus on acquiring other clinical labs as Quest has. In part, Lab Corp.—and for that matter Quest—do not need incremental lab space in order to grow. When they acquire a smaller clinical lab, what they are really buying is the acquiree's book of business. In fact, consolidating and automating testing sites are integral parts of Quest's cost-cutting strategy."

At investor-day ceremonies on Nov. 5, Quest related that it was consolidating five major testing sites in Massachusetts and Connecticut. It said it aims to reduce 321,000 square feet into a single facility in Marlborough, Mass. The new lab will measure a mere 204,000 square feet. Jim Davis, senior vice president of operations of Quest, provided a glimpse into the automated, people-light future: "We're going to take that one step further in Marlborough, and by the middle of next year we will have that lab completely automated, meaning the specimens will flow, they will be sorted, they will be aliquoted, they will move to the analyzers and from the analyzers they will move into storage—most of that done without any human intervention."

Price deflation is the lot of an investor-owned clinical lab in its day-to-day business; asset inflation is the backdrop to its financing activities. Lab Corp., drawing back from the fancy prices attached to medical-testing businesses, recently disclosed plans to purchase Covance for $5.6 billion, a consideration that values the acquiree at 13.3 times trailing EBITDA. Covance runs drug trials for pharmaceutical companies. Just how small is the overlap between Lab Corp.'s stock in trade and Covance's line of work is apparent from the meager savings that the acquirer expects to realize after the deal is done. Lab Corp. speculated that it might find $100 million in savings, some of which will stem from "the elimination of redundant public company expenses." (Whenever one public company acquires another, there are always "redundant public company expenses" to be cast out.) What Covance gives Lab Corp. is the prospect of growth in an industry that is not now suffering from price pressures.

"Now" is the operative word, as technological change has a way of dashing even the best-laid plans for cost and revenue. Thus, Celera Corp., which is today a part of Quest, became the first company to complete a full sequencing of the human genome. The cost of this feat—it was in the year 2000—was $300 million. Nowadays, Illumina Inc.'s HiSeq X Ten machine can do the same task for $1,000.

Then, in 2003, Elizabeth Holmes, age 19, dropped out of Stanford University—at the encouragement of her engineering professor, Channing Robertson—to found what is today Theranos Inc. Holmes had seemingly figured out how to run a panel of blood tests using a few drops of blood (approximately a hundredth to a thousandth of the draw for traditional tests) and process samples on site and on the same day—and not, as is still the norm in the lab-testing business, 24 hours later.

The clinical lab industry is deeply divided as to whether Theranos will succeed. "One tiny drop changes everything," is the corporate slogan. The roll call of the Theranos board of directors—Kissinger, Bechtel and Kovacevich are among the luminous names—certainly suggests that Holmes, now all of 30, is onto something. So does the roster of venture investors: Draper Fisher Jurvetson, ATA Ventures, Tako Ventures, Continental Properties Inc., and Larry Ellison, Theranos boasts a private market valuation of $9 billion, only $200 million less than Quest's public market cap.

As it is, Theranos has signed an agreement to roll out a machine in each of Walgreens' 8,207 drugstores. Assuming that the technology does work, such a presence would give Theranos a bigger retail presence (and a far more convenient one) than Quest and Lab Corp. combined. Theranos has published a schedule of test prices that are only a fraction of Medicare reimbursement costs.

You don't have to be bullish on Theranos to be bearish on Quest. Robert J. Boorstein, M.D., Ph.D. and founder of the ClasGroup Co., which consults with testing labs, sounded off in the Sept. 22 issue of *The Dark Report*, a publication focused on clinical labs. "My only disagreement with the information presented by *The Dark Report* is your skepticism that Theranos can be profitable charging just 50% of Medicare Part B clinical laboratory test prices," Boorstein concluded after declaring that he, for one, disputes that the Theranos technology can deliver the goods. "This is not a problem that is unique to Theranos. My understanding is that commercial laboratories are being presented with payment schedules from health insurers at rates less than that.

"In fact," Boorstein went on, "some capitated contracts pay as little as 10% to 20% of Medicare Part B prices for certain high-volume tests. Given the potential for Congress and CMS to enact deep cuts to lab test fees over the next seven years, we may end up considering a price that is 50% of today's Medicare rates to be quite desirable."

Final word goes to Lorenz: "With a short interest of 11.2% of Quest's float, the problems facing Quest are not exactly a deep, dark secret. However, at 15.8 times' trailing earnings, Quest's valuation seems to reflect the inflation of financial assets more than the deflation of the lab-testing business. The informed Quest insiders are regular and persistent sellers of their own stock. They should know."

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