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## New diagnosis

Quest Diagnostics (DGX on the Big Board), the nation's largest laboratory testing company, was a featured case study in technological progress in the Nov. 14 issue of *Grant's*. The falling cost of medical testing would, sooner or later, impinge on the fancy Quest equity valuation, we contended. As Mr. Market pretended not to notice—the stock price climbed 15.5% since we went to press—the payoff is going to have to come later. That it will, in fact, eventually come is the theme of the following update.

Quest is an institution of many financial facets. You could say, examining first-quarter results (2Q data are due on July 23, after we go to press), that revenues weighing in at \$1.8 billion rose by 5.3% vs. the 2014 period. So saying, however, you would be bound to add that Quest spent \$728 million to effect the acquisitions that delivered most of the growth. Excluding those add-ons, revenue grew by just 0.7%. More significantly, average sales prices actually fell by 0.7%.

"The first-quarter decline in average prices ('revenue per requisition,' is the company's preferred jargon) actually comes on relatively easy comparisons," colleague Evan Lorenz points out. "In the first quarter of 2014, average prices showed a 2.8% year-over-year decline. Comparisons will become more difficult for the balance of 2015. In the second, third and fourth quarters of 2014, pricing fell by 2.3%, 0.6% and 1.5% year-over-year, respectively.

"Pricing will continue to erode," Lorenz proceeds. "Federal regulations—notably the Protecting Access to Medicare Act of 2014—requires the

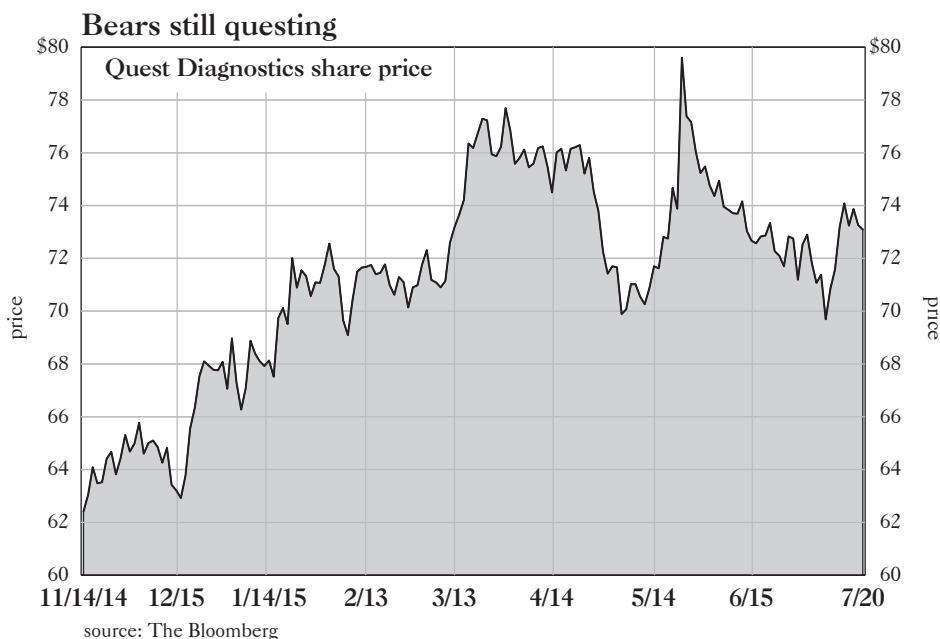
Centers for Medicare and Medicaid Services to reprice the fee schedule for Medicare-related clinical lab work within two years. The law allows CMS to cut lab test prices by up to 10% a year between 2017 through 2019, and up to 15% a year from 2020 through 2022. Any day now, the agency is expected to give an inkling of how big 2017 cuts might be. Medicare generates 14% of Quest's revenue."

The recent spate of health-care mergers may also pressure lab fees. In announcing its \$37 billion bid for Humana Inc. earlier this month, Aetna pointed to \$1.25 billion in cost savings ("synergies") by 2018. Companies like Quest seem certain to be commandeered into this all hands' effort.

"If you think that Aetna will close

the deal with Humana, then Aetna is going to bring in all the Humana [lab testing] volumes," an anonymous (and bruised) Quest short tells Lorenz. "Aetna has preferential rates. Humana has a contract with Quest, but my understanding is that it is not the same sort of advantageous deal that Aetna has. All that volume [from Humana] will be coming in, but will be coming in at a fraction of the price. That will happen probably in fourth quarter 2016."

Theranos is a name that figured in our pre-Thanksgiving analysis. It's the lab-testing upstart that was conceived by the now 31-year-old former prodigy, Elizabeth Holmes. You may recall that Holmes had ambitions to create an approach that, in comparison to the methods employed by Quest and its



ilk, was less time consuming, less painful and less sanguinary. In contrast to established lab companies, Theranos publishes set prices, and none of these tariffs is higher than half of the Medicare-allowed maximum.

As recently as last fall, the Theranos threat to the established testing companies seemed more hypothetical than imminent. It is no longer hypothetical. On July 2, the FDA granted clearance for Theranos' test to detect herpes simplex 1 virus IgG as well as the use of Theranos' system to conduct the tests. On July 16, the company received a waiver from the FDA to use its system outside of conventional clinical laboratories, the first such waiver the FDA has ever granted. The approvals have turned formerly skeptical heads.

It's important to note that Theranos did not need FDA approval to run its tests in its own labs; Quest and Laboratory Corp. of America Holdings, the other main publicly listed testing company, can do what they like on their own premises. The premises that Theranos covets are a few square yards in a Walgreens drugstore (it already serves 40 Walgreens in Arizona and one in Palo Alto, Ca-

lif.), or a modest presence inside a so-called wellness center. So the FDA's approval for off-site testing is a ringing validation of the unorthodox Holmes vision. She says she means to secure FDA approval on more than 120 additional tests.

"Theranos' low prices and promise of fast and painless testing is garnering attention from insurance companies," Lorenz reports. "On July 8, Capital BlueCross, a central Pennsylvania insurer that covers 725,000 consumers, signed a deal making Theranos its preferred lab. On July 15, AmeriHealth Caritas, a for-profit, Medicaid-managed care insurer that covers 6.6 million consumers in 16 states and the District of Columbia, announced a partnership with Theranos.

"Our afore-quoted bear has gone to the lengths of having blood drawn at Theranos' locations," Lorenz goes on. "Regarding the Theranos testing experience, our source finds that it lives up to the company's sales pitch. It is quick, painless and cheap. 'I've spoken to doctors in the Arizona region,' the DGX bear tells me. 'They direct patients to Theranos, specifically most of their self-pay patients, a lot of Medi-

care patients, and some patients who had not reached their deductible yet.'"

Theranos has been quietly making inroads through other channels, including the Cleveland Clinic and Intermountain Healthcare, a 22-hospital system in Utah and Idaho. Drawing less blood per test, the Theranos system is winning adherents among pharma companies, whose clinical trials require frequent testing. In June, the Carlos Slim Foundation signed a deal with Theranos in a public health initiative in Mexico designed to combat obesity.

The risk to Quest is not that Theranos' share of the testing market will rise to, say, 20% in 2017 from a rounding error today. After all, Theranos still faces the formidable work of building a nationwide network of labs and testing centers. The clear and present danger is that the margins of Quest et al. from Theranos' transparently low prices. At 17.2 times trailing earnings, Quest is hardly valued for the risk of continued price erosion in the absence of Theranos, much less for the risk of price erosion with Theranos.

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