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Quest Diagnostics' (DGX) CEO Steve Rusckowski on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-22-19 Earnings Summary

Press Release SEC *10-Q*

EPS of $1.76 beats by $0.05 | Revenue of $1.96B (3.55% Y/Y) beats by $15.09M

Earning Call Audio

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Quest Diagnostics Incorporated (NYSE:DGX) Q3 2019 Earnings Conference Call October 22, 2019 8:30 AM ET

Company Participants

Shawn Bevec – Vice President of Investor Relations

Steve Rusckowski – Chairman, Chief Executive Officer and President

Mark Guinan – Chief Financial Officer

Conference Call Participants

Ralph Giacobbe – Citi

Bill Quirk – Piper Jaffray

Donald Hooker – KeyBanc

Erin Wright – Credit Suisse

Michael Newshel – Evercore ISI

Kevin Ellich – Craig-Hallum

Jack Meehan – Barclays

Kevin Caliendo – UBS

Brian Tanquilut – Jefferies

Derik de Bruin – Bank of America

Matt Larew – William Blair

Alexa Desai – Morgan Stanley

Mark Massaro – Canaccord Genuity

Eric Coldwell – Baird

Stephen Baxter – Wolfe Research

Operator

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Now I’d like to introduce Shawn Bevec, Vice President of Investor Relations for Quest Diagnostics. Go ahead, please.

Shawn Bevec

Thank you and good morning. I am here with Steve Rusckowski, our Chairman, Chief Executive Officer and President, and Mark Guinan, our Chief Financial Officer.

During this call, we may make forward-looking statements and will discuss non-GAAP measures. We provide a reconciliation of non-GAAP measures to comparable GAAP measures in the tables to our earnings press release. Actual results may differ materially from those projected. Risks and uncertainties that may affect Quest Diagnostics' future results include, but are not limited to, those described in our most recent Annual Report on Form 10-K and subsequently filed Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

For this call, references to reported EPS refer to reported diluted EPS from continuing operations and references to adjusted EPS refer to adjusted diluted EPS from continuing operations excluding amortization expense. References to adjusted operating income for all periods excludes amortization expense. Finally, growth rates associated with our long-term outlook projections – including total revenue growth, revenue growth from acquisitions, organic revenue growth, and adjusted earnings growth are Compound Annual Growth Rates.

Now, here is Steve Rusckowski.

Steve Rusckowski

Thanks Shawn. And thanks everyone for joining us today. This morning, I'll discuss the third quarter and review progress on our two-point strategy. Then Mark will provide more detail on the results and take you through updates to our 2019 guidance.

We had a solid quarter of top and bottom line growth. While PAMA reimbursement pressures persist throughout the industry, our expanded network access and laser focus on driving operational excellence are enabling growth.

Based on our progress to date we have updated our outlook and are well-positioned to meet our commitments for the year. For the third quarter, we grew revenues 3.5% despite continued reimbursement pressure. Reported EPS was $1.56, up nearly 3% from the same period in 2018. Adjusted EPS was $1.76, up nearly 5%. Volume growth remained very strong at 5.1% and year-to-date volume growth is up 4.3%.

Now, I'd like to briefly update you on the three fundamental changes in the laboratory marketplace that we discussed at last year's Investor Day. And as you know they are our PAMA, our expanded network access and increased consumerization of healthcare.

First, PAMA, the reimbursement pressure remains a catalyst for structural change in the marketplace. And there is mounting evidence that PAMA is hurting this industry. We see and hear the negative impact that PAMA is having whenever we evaluate potential lab acquisition targets. And CAP Today, a respected industry journal, recently highlighted how PAMA and other reimbursement pressures are already starting to drive consolidation in the industry.

As you know, here at Quest, we took a series of actions earlier this year to further reduce our costs to align with PAMA cuts. Some decisions that we made were difficult, and our employees have felt the changes. More PAMA reimbursement cuts are coming in 2020. Our industry continues to fight PAMA's flawed implementation in the courts and in Congress.

We recently received a favorable U.S. Court of Appeals decision to allow the lower court to review the merits of ACLA's case. ACLA submitted its initial brief last week, and a decision is expected in 2020. This is encouraging news, and so is the introduction of the Laboratory Access for Beneficiaries Act, or LAB Act, introduced in June by six members of Congress from both sides of the aisle and now with nearly 40 cosponsors. ACLA is also working to build support for a Senate companion bill to include the LAB Act in a larger end-of-year health care extender bill.

The second fundamental change affecting our industry is our expanded network access and payers becoming more focused than ever on driving better value in their lab spend. We are partnering with UnitedHealthcare to move testing volume to high-value labs like Quest from high-cost hospital and out-of-network labs. UnitedHealthcare began offering a product with zero dollar member out-of-pocket charges for laboratory testing for the majority of fully insured lives in select states on October 1. UnitedHealthcare will also make the lab savings program available for their self-insured employer groups beginning in 2020.

And then finally, we continue to see the ongoing consumerization of health care with more and more health care costs borne by consumers. In September, the Kaiser Family Foundation reported that the annual premiums for employer sponsored health care coverage grew 5% for families, surpassing $20,000 for the first time. The number of employees in high deductible health plans has increased over the past decade.

Turning to our recent progress, the first part of our two-point strategy is to accelerate growth, which has five elements. To grow 2% per year through accretive, strategically aligned acquisitions; expand relationships with health plans and hospital health systems; offer the broadest access to diagnostic innovation; be recognized as the consumer-friendly provider of diagnostic information services; and then finally support population health with data analytics and extended care services.

Now let me take you through a few highlights from our strategy to accelerate growth in the quarter. Our acquisition pipeline remains strong. As we've said before, most deals in our pipeline are taking more time to develop than they have in the past.

Conversations with hospital systems are getting broader. Hospital CEOs are also interested in how we can help them with their professional lab services and taking on more of their reference work. As a result of this complexity, proposed relationships take longer to develop.

Hospital systems are also interested in learning more about our recently unveiled Quest Lab Stewardship, an innovative new service that employs machine learning to help optimize laboratory test utilization. We have partnered with hc1, a health care IT company, to provide a solution that gives Quest a differentiated offering in a competitive hospital marketplace.

We continue to see revenue and volume growth as a result of our expanding network access. In aggregate, growth continues across our top 50 major health plan customers. Key test growth drivers in the quarter included drug monitoring, continued strength in tuberculosis testing in both QuantiFERON and T-Spot; STD testing; and CardioIQ. Each of these test categories posted solid contributions to revenue growth in the quarter.

The second part of our two-point strategy is to drive operational excellence. We remain on track to deliver 3% cost efficiencies for 2019 by continuing to drive increases in productivity. We have some examples which include using digital technology to enhance the customer experience. We now have more than 8.2 million patients now making appointments and receiving their results through our MyQuest digital platform.

We’ve continued to drive productivity improvements across logistics, patient services and lab services, enabling us to reduce our overall cost per laboratory requisition. We are also putting new innovations to work while reducing costs. We are in the process of consolidating and simplifying our immunoassay platforms, moving to a single supplier. This approach enables greater throughput, a more efficient footprint, and is expected to save tens of millions of dollars per year.

Now, let me turn it over to Mark, who will take you through our financial performance. Mark?

Mark Guinan

Thanks, Steve. In the third quarter, consolidated revenues were $1.96 billion, up 3.5% versus the prior year. Revenues for Diagnostic Information Services grew 3.7% compared to the prior year driven by strong volume growth and acquisitions, partially offset by higher reimbursement pressure. Volume, measured by the number of requisitions, increased 5.1% versus the prior year. Excluding acquisitions, volumes grew 3.7%.

We benefitted from an extra revenue day in the third quarter, while the impact of Hurricane Dorian was a modest volume headwind. The net impact of these two items added roughly 1% to organic growth in the quarter.

Recall, we also highlighted last quarter that we recently exited some capitated contracts. In the third quarter, this change represented a headwind of nearly 1% to our organic volume growth.

Importantly, we continued to see a modest acceleration in our volume growth associated with our UnitedHealthcare contract. Revenue per requisition declined by 1.2% versus the prior year primarily driven by higher reimbursement pressure.

Unit price headwinds were approximately 2.5% in the third quarter. This includes the impact of PAMA which amounted to a headwind of approximately 120 basis points. As a reminder, the PAMA impact includes both direct cuts to the Clinical Lab Fee Schedule as well as modest indirect price changes from Medicaid and a small number of floating rate contracts.

Reported operating income was $313 million, or 16% of revenues, compared to $304 million, or 16.1% of revenues last year. On an adjusted basis, operating income was $349 million, or 17.9% of revenues, compared to $333 million, or 17.7% of revenues last year. The year-over-year increase in adjusted operating margin was primarily driven by strong volume growth and ongoing productivity improvements related to our Invigorate initiatives, partially offset by higher reimbursement pressure. Additionally, patient concessions are down year-over-year.

Reported EPS was $1.56 in the quarter compared to $1.53 a year ago. Adjusted EPS was $1.76, up approximately 5% from $1.68 last year. Cash provided by operations was $895 million year-to-date versus $905 million last year. Capital expenditures were $228 million year-to-date, compared to $232 million a year ago.

Now, turning to guidance, our updated outlook for 2019 is as follows: Revenues expected to be approximately $7.72 billion, an increase of approximately 2.5% versus the prior year. Reported EPS expected to be between $5.48 and $5.53 and adjusted EPS, to be between $6.45 and $6.50.

Cash provided by operations is still expected to be approximately $1.3 billion and capital expenditures are expected to be between $350 million and $400 million.

I will now turn it back to Steve.

Steve Rusckowski

To summarize, we had a solid quarter of top and bottom line growth. While PAMA reimbursement pressures persist throughout the industry, our expanded network access and laser focus on driving operational excellence are enabling growth. Based on our progress to date we have updated our outlook and are well-positioned to meet our commitments for the rest of the year.

Now, we'd be happy to take any of your questions. Operator?

Question-and-Answer Session

Operator

Thank you. We will now open it up to questions. [Operator Instructions] Our first question comes from Ralph Giacobbe with Citi. Your line is open.

Steve Rusckowski

Good morning, Ralph.

Mark Guinan

Good morning, Ralph.

Ralph Giacobbe

Good morning. Good morning. Thanks. I guess I wanted to ask on the pricing side, and just your comments on sort of the higher reimbursement pressure. I guess what's – just help us on sort of what's driving that outside of PAMA? And then if you could maybe just level set the expectation on sort of where expectations are for that pricing mix that kind of going forward, exclusive of PAMA? Thanks.

Steve Rusckowski

Mark, do you want to…

Mark Guinan

Sure. So as we've shared before in the Investor Day last year, then also coming into this year, this year's pricing pressure is primarily driven by two factors, one is PAMA. The second one is getting back in with United. We moved from out-of-network rates to a market-based in network rate. So obviously, we have grown our volume dramatically. As we've said this year, we expected and we – still we are delivering enough incremental value to offset the price set, but it is a significant price headwind relative to the rates we were being reimbursed as out-of-network lab.

You don't have the typical pricing pressure that this industry has faced in the past. We've talked about it being for around 100 basis points or less. Number of those pricing pressures are coming from the client bill, it's not all third-party reimbursement where we're contractually agreed with the health plan and what those rates are in the hospital business and also where we sell directly to physicians and they're allowed to build a third party. There is a lot of competition. A lot of pricing pressure in that area and so while we've talked about, we're going to be price disciplined when we certainly walked away from some contracts that haven't made sense. The reality is that it's a very competitive environment. And that has not really changed.

So the big change over the last two years, obviously PAMA last year, but it wasn't fully implemented, because you had some offsets to it in the first year that we've talked about previously. This was the first year of the full 10% of PAMA. And then additionally, we have the United price as well. And going forward, as we shared, we would expect this to get back to more of its historical rate. I'm not going to give any specific guidance for a given year. But there is no reason to believe once we get through the transition period in the United that we should be really facing in kind of the traditional pricing pressure in PAMA.

Ralph Giacobbe

Okay. And could you just quantify that UNH pricing pressure this year?

Steve Rusckowski

Ralph, it's going to be $40 million to $50 million.

Ralph Giacobbe

Okay. All right. Thank you.

Operator

Our next question comes from Bill Quirk with Piper Jaffray. Your line is open.

Steve Rusckowski

Hey, Bill.

Bill Quirk

Thank you. Good morning, everyone.

Steve Rusckowski

Good morning.

Bill Quirk

So Steve, I want to follow up on a comment that you made concerning the decision to consolidate the immunoassay vendors. Can you speak a little bit about whether or not there's an opportunity here to consolidate some of your other testing methods things like clinical chemistry and hematology and such. And if so, can you just help us think a little bit about the timing? This is something we should think about over the next couple of years to help offset some of the PAMA pressure. Thanks.

Steve Rusckowski

Yes, sure, absolutely. So Bill, we were working on this for about seven years, getting smarter and more strategic with all our suppliers, and so we've done a lot of consolidation in the past and we'll continue to do more in the future. So as far as immunoassays, we're close to deciding on the supplier. I believe that will be announced shortly who that is. Of course it's a nice opportunity. And this is all part of our 3% productivity gains that we are dialing in to be able to offset PAMA. We need it to be able to offset PAMA deliver on the earnings uplift that we've provided at Investor Day.

And so part of that 3% is working with our suppliers and part of that working with the suppliers and the example of that is immunoassay while there is others. Another example would be the automation we're putting in place in some of our newer facilities, particularly we're investing this year in our branding facility here in New Jersey – in Clifton, New Jersey. It's a big project for us. That will have us new platform, but equally it will have us our latest approach to automation, which will increase our productivity, but also allow us to consolidate some facilities into one, so we get some productivity gains from that. But that's all part of that 3% when we need that 3% to offset the price pressure particularly with PAMA next year and maybe the year after.

Mark Guinan

And I just want to add some color there, Bill, make sure they understand this is not just consolidating our purchases. This is actually a new innovation in the platform where we can do multiple tests that previously were performed on separate pieces of equipment on a single piece of equipment. So this will drive, not just procurement efficiencies, but actually will drive operational efficiencies in our labs.

Operator

Our next question comes from Donald Hooker with KeyBanc. Your line is open.

Steve Rusckowski

Hey, Donald.

Donald Hooker

Great. Good morning. So I – maybe you guys in terms of that new collaboration you announced with hc1. I know you guys do a lot of interesting things in the population health space. I'm just trying to maybe – can you elaborate on that a little bit? What exactly are you doing? I mean is this something that I guess you're...

Steve Rusckowski

Sure. Sure. What we're doing for our hospital client as part of our five-point strategy, we talk to them about three things in regards to the lab strategies. One is, can we make them more efficient in running their inpatient laboratory? So this is where we talk about Professional Laboratory Services or sometimes we use the acronym PLS, and we continue to have that dialogs about making them more efficient.

We can – with good evidence now, save them about 10% to 20%. Part of that typically also is looking at the sophisticated send out of testing referred to as reference testing. And in that regard, consolidated was buying from – like potentially give them a better price. But the third part that we're looking at and this new offering allows as a tool to do a better job of getting smarter about what they're testing in the hospital is interrogate their order patterns and look for variation of their order patterns and look at ways of optimizing what the order within the hospital.

And there's two part to that. One is to get more efficient at what you're ordering. So maybe third quarter as much in some cases, you should also order more because it's smarter diagnostic workup for the inpatient today, but the second part of this, which is more – even more intriguing what many hospital administrators are interested in is making sure that we have the right diagnosis.

And if you look at the total quality and outcomes for our hospital stay, there's nothing more expensive than buying diagnosis. So what this tool allows us to do is to work with our clients on getting smarter on their inpatient diagnostics and as part of that, we clearly become more strategic than this vendor providing reference testing within that account.

And then finally, the third piece of what we work with hospital systems when we have those discussions is you want to stay in the outreach business and we have bought some outreach businesses from hospitals. We have some within our numbers for this year and will continue to aggressively pursue buying outreach businesses as this industry consolidates. And I would tell you that many hospital systems are now well aware of PAMA and well aware of other reimbursement pressures they are having in their laboratory outreach business. So, as we mentioned in our commentary that funnel of discussions continues to grow.

Operator

Our next question comes from Erin Wright with Credit Suisse. Your line is open.

Steve Rusckowski

Hi, Erin.

Erin Wright

Hi. In terms of the timing and magnitude of contributions from the managed care access, I guess, can you break out what you're seeing in terms of underlying market growth and what portion of volume may be stemming from the managed care contracts and possibly also the PLN in early days and are you still anticipating those contributions to ramp from here? How should we conceptually be thinking about that ramp? I'm not asking for 2020 guidance, but how should we be thinking about that ramp into 2020?

Steve Rusckowski

Sure. So what will share with you – we always shared this every quarter. It feels like the market is stable. We don't see any notable changes in terms of volume increases within the marketplace both outside the hospital, and also inside the hospital so stable. So if you look at volume growth, we're clearly gaining share. And a large portion of that share of gains is coming from managed care relationships.

What we have also said is that our access changes, which is the best in over a decade, we'll continue to grow. It will continue to grow this year in 2019, but it will also have growth in 2020 and probably in 2021 as we take advantage of that opportunity that we see in front of those. That will be helped in 2020 for certain with – for lab network, particularly with UnitedHealthcare. So you should look for in 2020 continued growth again because of our expanded network access. So Mark, anything you'd like to add to that?

Mark Guinan

Yes. So, you asked about the PLN, it's still very, very early. To this date, I'd say very little, if any growth has come from the PLN is still in front of us, which is the good news. We talked at Investor Day about kind of three tranches of volume growth, Erin. We sized the new managed care access at about $1 billion at our price, our fair share. We fully expect to get to our fair share. But it's going to take several years there was a easier to convert accounts obviously came quickly, we call them Quest loyalist where we had the rest of the book of the office and they were sending some of the managed care work that we were out-of-network to those, to other labs that were in-network and they immediately moved that to us once we were in network.

We never had some of the accounts where they have multiple labs. We showed you the picture when they were three, four sometimes five boxes outside. We've done a better job of consolidating some of that getting a more larger share of wallet per se in those positions that will take a period of time, but certainly, we've gotten some growth from that, but that will continue into the future.

And then there was the ones where we have had no, none of the work and a lot of that is in the hospital stay, hospital outreach and in some of the physician-owned laboratories that's where we really think the preferred lab network is going to be a big driver. We would be able to have a very simple message to patients. Hey, if you use one of the preferred labs and obviously we're one of the five zero out-of-pocket. That's a very simple message instead of trying to compare how expensive, what option might be the there, it's free to view if you use this lab. So we're very confident, very excited. This will be a multi-year tailwind and we're going to get to that fair share eventually of about $1 billion in our price.

Operator

Our next question comes from Michael Newshel with Evercore ISI. Your line is open.

Steve Rusckowski

Hi, Michael.

Michael Newshel

Hi, good morning. Maybe to follow-up on that. Do you have any visibility at this point after the selling season from United on the level of uptake in the self-insured base for the PLN for 2020

Mark Guinan

They have not shared specific information, obviously. They are questions you could ask them because we're not the only preferred lab. So we obviously get the same information that preferred lab network providers do. They talk to us about, as we've shared the states where their role in the south making this available, and then they talk to us about the fact that their marketing into those whole insurance sponsored plans for 2020, rolling that out, still very early in that process, and they didn't give us any specific proportionality or percentage of their overall insured lives that are adapting this, but they – I'm sure you've heard them talk about it, we've heard them talk publicly and in the conversation we have, they are very, very confident that this is going to be something that people will embrace and that is going to make a difference.

Operator

Our next question comes from Kevin Ellich with Craig-Hallum. Your line is open.

Steve Rusckowski

Hey, Kevin.

Kevin Ellich

Good morning. Thanks for taking the question.

Steve Rusckowski

Good morning.

Kevin Ellich

Hey, Steve. Two quick things. So first M&A pipeline. You said that the deals are taking a little bit longer to materialize. Wondering if the environment has changed or if this is what you've experienced historically. And then also could you talk about maybe any tailwinds you're seeing from the opioid testing and the opportunities within behavioral health facilities?

Steve Rusckowski

Yes. Sure. So on the first one, as I mentioned in our opening remarks, these deals are getting bigger and more complicated. And if it's more complex, it takes more time and there is good news in that and there is bad news in that. One is, it takes more time. That's bad news. The good news is, the bigger the more complicated. It's therefore we're clearly having discussion around how they could be – their partner for laboratory services around the three topics that I mentioned earlier.

And what I did also share is that the interest level around what we can do when partnering continues to grow because of more people are well aware of the pressure on this portion of their business. I would say that was not nearly where we were last year at this time. So if you look at our growth rate from acquisition year-to-date, they're – it's just a little shy of that 2% we indicated last year. We're well north of that 2%.

We still feel confident that over an extended period of time, we'll continue to be 2% or greater. And so, we feel confident between the three buckets that we acquire. One is hospital outreach, [indiscernible] (0:29:03) lot of engagement around that. Second is, regional laboratories. As I mentioned in my remarks, there continues to be interest in evaluating options for smaller operators because of the pressures that they see. And then finally, we continue to build capabilities and we have a number of acquisitions in the past around that. A good example of this immune attack, which is bringing us new capabilities around tuberculosis testing and also fit for an illness testing.

So all three continue to be our focus going forward and you will see that and we're still confident around our guidance we provided around 2% on a CAGR basis over a multi-year period of time.

Mark Guinan

And you asked about opioid testing and the tailwind certainly our prescription drug monitoring business, which is subset of that opioid testing has been a strong growth engine for us for a number of years and continues to be a nice growth driver. Like anything else, when something gets large enough, the payers start putting in policies and all sorts of barriers to reimbursement that dampen that somewhat, despite some of those restrictions around frequency of testing, pre-authorization, and other things that they're putting in, it's still a nice growth driver for us. It just will be even larger if they hadn't made those changes.

Operator

Our next question comes from Jack Meehan with Barclays. Your line is open.

Steve Rusckowski

Hi Jack, good morning.

Jack Meehan

Good morning. So I just wanted to focus on the margins here, so in the quarter, nice to see the expansion. Can you maybe walk us through the moving parts between pricing impact, efficiency programs in the calendar? And as we look to 2020, as you pull all these pieces together, do you think – what's the right way to think about, are margins flat is PAMA too big of a headwind to grow through? What are some of the things that you're thinking about?

Steve Rusckowski

Yes, so let me first touch Jack on the longer term. So I'm not going to talk to 2020. But what I did talk about at the Investor Day was on a full year outlook that we could grow earnings faster than the top line. And talked about the assumption, although that may not play out depending on how we deploy our cash, but that's on the flat share count, so therefore we're actually growing earnings not earnings per share. So that implies margin expansion that I can tell you that we are not expecting some sort of the tax windfall. So that's before tax margin growth.

I can't assure you that will happen every quarter. I can't assure you that I'm not going to get into 2025 adding every year, but over multiple years, we expect to grow our earnings faster than our top line. And it's really having the efficiency program continue, we talked about it being 3% per year, we've got really good at that. We need that. We'll continue to do that with over time tempering pricing headwinds. In this quarter, we shared the pricing headwinds of 250 basis points. Obviously, that all drops to the bottom line for a very small piece for the bad debt element, but basically it drops to the bottom line.

So we had enough efficiency and some lift from volume, how much of that is the extra day, how much of that is just the volume growth. Obviously, we have a higher drop through we shared on organic volume growth, enough to offset the pricing headwinds and basically hold our margin pretty flat in the quarter.

So I may be getting any more precise than that, I'd be stretching my credibility and ability to give that map. So I would just say that, you can see that despite some pretty significant pricing headwinds, is how their margins in this quarter and that as we continue to drive strong organic volume growth and deliver our 3%, over a period of time, we're going to grow our earnings faster.

Operator

Our next question comes from Kevin Caliendo with UBS. Your line is open.

Kevin Caliendo

Hi. Thanks for taking my call. Could you talk a little bit about the fourth quarter guidance? The revenue guidance is in line with model, the EPS fall short. I'm just wondering if there is any accelerated spending, are you may be trying to position better for 2020 by spending more in 2019? Can you give us a little color around the fourth quarter and may be higher thinking about spending in 2020?

Steve Rusckowski

Yes, so we've raised our guidance for the year. Importantly, we're signaling stronger finish to the year than we did at the beginning of the year. And until now we've not signaled anything above original guidance. So, hopefully people are taking that as a positive message, which we're saying based on our performance through three quarters of the year and what visibility we have for Q4, we're feeling confident that we're going to over-deliver relative to what we said at the beginning of the year.

So, in terms of the spending, there's nothing out of the ordinary in Q4. The only thing that's out of the ordinary is the easy compare on the top line which we've talked about.

Operator

Our next question comes from Brian Tanquilut with Jefferies. Your line is open.

Brian Tanquilut

Good morning guys.

Steve Rusckowski

Good morning.

Brian Tanquilut

Mark just to follow-up on Jack's question earlier, as I think about the G&A line, you've obviously done a good job bringing the G&A percentage down. It flattened out this quarter at about 17.8%. So as I think about your efficiency program, is there more to squeeze out of that or how should we be thinking about that number, it seems like it's bottoming out here in this 17.8% range?

Steve Rusckowski

Let me start on this. For some reason, there's always a lot of focus around G&A thinking about a lot of our invigorated savings show up in the expense categories. To the contrary, most of our invigorated savings actually sort of show up in our costs of sales. So if you think about what's in our expense category, a lot of it is G&A and we've made really good progress over the last seven years. So getting more efficient with everything that's in the category in the P&L, from IT cost to cost running our finance organization, the cost associated with our billing operations, with our relationship with Optum. And outside the general and administration, it's our sales and marketing costs, which we're always evaluating and getting more efficient.

So we have taken a lot of cost out already. And we're also leveraging that fixed cost going forward. So the lift we generally get now has to do with that operational leverage related to the top line growth while maintaining the same cost perspective and that's what you see this year. So a lot of the 3% productivity gain will show up in productivity gains in our cost of sales and not in the expenses.

Mark, do you have anything you'd like to add that?

Mark Guinan

Yes, I just would like to add that yes, over time, well Steve is absolutely correct that a large proportion if not a majority of that efficiency is going to drive margin and gross margin will be in the cost of sales will continue to focus on G&A. You can't really look quarter-to-quarter. In this quarter, we had some couple of high-cost health claims. Over time, we're going to deliver what we expect, and we've done a really good job in managing, it's very, very minor increases in our self-funded employee healthcare costs. But in a given quarter you get a couple of large claims that can make some noise quarter-to-quarter.

So there's no trend, where there's – nothing should be read in terms of we've lost our ability to continue to drive efficiency, there's always going to be noise on that line quarter-to-quarter.

Operator

Our next question comes from Derik de Bruin with Bank of America. Your line is open.

Derik de Bruin

Hi, good morning. How are you?

Steve Rusckowski

Hey, good morning.

Derik de Bruin

Good. Hey, I just want to follow – two questions. One is a quick follow-up to Bill's question on the vendor consolidation, platform consolidation. Can you talk a little bit about that process and that how is that going to look and sort of like how you're judging the different vendors and basically how many you have now particularly the IA and going down?

And then the other question I wanted to follow-up on was, when you look at the fourth quarter last year, obviously you had a number of weather issues, but there were issues of patient concessions, lower cash collections, in that sense. Can you just sort of talk about going into the fourth quarter how we are relative to some of these issues, I know you mentioned concessions were down. But just to talk a little bit more about the comps and some of the different things you're sort of going on in fourth quarter versus…

Steve Rusckowski

Okay, so let me take the first part Mark will take the second part. And the first part, so this is a comprehensive review that we perpetually look at with our suppliers on how we run our laboratories. And we work actively with all our suppliers and that over the past seven years we've worked hard to make sure that we really have more of a strategic relationship with all our suppliers, particularly those that are driving a large portion of our spend. And so in that regard, in the IVD automation states, there is consolidation with a number of those platforms as Mark mentioned. And there are a number of suppliers that we buy from that are bringing to the marketplace platforms that will allow us to replace up to about five different work cells with different manufacturers over time.

And so what we have done is evaluate those vendors that have a product either in the marketplace or will have a product in the marketplace and we do that through a review process with their sales force on understanding what they'll have, and what they'll have for functionality at one time, and then also what the economics around their offering are. We narrowed that down to a few. We actually put in place a few of those platforms in some of our facilities to do some trial runs and then we're at the final strokes of selecting one of those suppliers going forward. And we believe that we will choose a vendor that meets all the requirements of what we need.

And yes, a portion of this is economics. That is how cost – how much productivity we're going to get for getting more throughput by – being able to consolidate those operations. But also we think about it holistically. You need to make sure that you have good confidence around their ability to service us, good confidence around their quality, good confidence around what's in their installed base. So it's a very comprehensive, operational review of who will be our strategic provider for this new platform going forward. And as I said we're at the final strokes of deciding that and shortly it will be announced.

Mark Guinan

Yes, so on your second question, last year there were a couple of drivers that led us to the change in estimates and obviously the change that we made in Investor Day on our outlook for 2018. Two of them really relate to patients. The first one was that there was more patient responsibility in the year than we saw it coming. And again, we're always accruing based on a forward-looking expectation of how the revenue is going to play out. We looked at all the available data at the beginning of the year as we shared whether great growth with the amount of people with high deductible plans, we assumed it would be a pretty flat year in terms of the proportion of our revenue from patients. And instead what happened was there were more patient responsibility because the deductibles themselves have gone up markedly as we found out in the September timeframe, which started to actually validate why our cash collections were lagging what we expected from the payer.

So anytime, as we've shared, we almost collect a hundred percent of the accepted claims that we're owed from third party payers. And we've shared that we collect about $0.70 on the dollar from patients. So you move 1% of revenue from the third party to the patient. That's a 30 basis point headwind. So it's pretty significant.

The good news is this year nothing changed significantly from last year. We're very confident with that, there was no surprise. Obviously going in, we were very, very diligent in watching that, being conservative and there's no surprises in terms of the proportion of our revenue coming from patients.

The second piece really with patients was we had more patient concessions, not just because more revenue was coming from them, but we actually had some issues we've talked about in our lab conversion in the south. And that delays some billing because of the way these conversions go. And because of that the more bills age out, the more you're going to have concessions less like you are going to collect it. So that's well behind us, we're fully converted, we don't have that anymore. So that's behind us.

And then also related to that we had some higher level of denials because of some time with filings, and so on, because lab conversion themselves we always have been dealing with denials, but they spiked the mid to late last year when we went to this lab conversion. So when you add all those things up, they've been cleaned up. The issues that we had last year are well behind us.

Operator

Our next question comes from Matt Larew with William Blair. Your line is open.

Steve Rusckowski

Hi Matt.

Matt Larew

Hi. Good morning. I wanted to ask for an update on progress in the retail setting, first just broadly in terms of the footprint transformation in the Walmart and Safeway stores. And then also anything that you think you are doing with the new Walmart health initiative. I know there's a first center that just opened up in Georgia that you're participating in.

Steve Rusckowski

Yes, so we're continuing to move forward with our retail strategy as we call it. We have about 2,100 patient service centers and of which can you characterize from above 35% to 40% of those are more retail like, several of which are within Safeway stores and Walmart. The Safeway relationship continues to be a good one. We actually have some new opportunities with Safeway going forward as we kind of work that relationship, so we're optimistic there.

And then second, as we continue to build our presence with Walmart as well. And as you mentioned, they opened up new health concept store and we are their laboratory provider for that store, so they're still working through how that works. And as you know if you know anything about Walmart, they probably like a lot of things and they're seeing how well that goes to be able to tune out and we're working with them proactive on that content going forward.

And as what we said is our goal is to be north of 50% of our patient service centers. So we have some ways to go. And there's a number of things for us, one is we think it's a better customer experience, consistent with our strategy, could be the most consumer-friendly laboratory. And we think this will continue to be a differentiator for us in the marketplace.

Second is it's better for employees in a lot of ways and it also allows us to manage the demand and when people are there if we can have larger patient service centers with more providers, it just gives you a lot more operational flexibility to manage the demand based upon location and time of day that patients are coming in over extended period of time.

And then finally as the patients really the feedback is quite good. They come in, they have flexibility to walk the store where they wait they have flexibility to do some shopping after their visit. Then we believe that improvement in access and the quality of that access will allow us to differentiate ourselves in the marketplace and pick up share gradually over time. So it’s going well, we’re pleased with it.

And then lastly, I will just say, yes, we have the relationship with Safeway, and yes we have relationship with Walmart, but we continue to work with others in the marketplace, so we continue to work with CVS, Aetna, the MinuteClinic and what we’re doing around their strategy is they are a partner of ours.

Operator

Our next question comes from Ricky Goldwasser with Morgan Stanley. Your line is open.

Steve Rusckowski

Hey Ricky. Good morning.

Mark Guinan

Good morning Ricky.

Alexa Desai

Good morning. This is actually Alexa in for Ricky. Thank you for taking my question.

Mark Guinan

Hi, Alexa.

Alexa Desai

I just wanted to come back to the United Health PLN. You guys mentioned, I think, in your earlier remarks that they're offering starting October 1, zero dollar member out-of-pocket charges. So I guess my question is, are there any other things that are looking for to do over the balance of the year to continue kind of incentivizing the use of the PLN and how does that zero pocket compared labs not in the network?

Steve Rusckowski

Mark you want to take that?

Mark Guinan

Yes so for labs not in the network, it would be the typical out-of-pocket determined by their plan benefit design. So, with a high deductible plan they just had some sort of cover insurance, but there won't be zero. So if you think about the average requisition being somewhere between $40 and $50 and typical patient responsibility over time, employing proper responsibility over time by be it 20% to 25% of their healthcare dollars, with the balance being paid for by the company, you can do the math. Now that's an average. Obviously there's some very high cost tests. So it'd be a big, big advantage if you have a genetic test or some of the other screening tests that could run hundreds of dollars.

But just the simplicity of the message of not having to worry that, hey the same series of tests would be $50 from a national lab and $500 from this hospital. And what does that mean for me? It's just you don't have to worry about it. They're not as good and it's not just about price, it's also about quality, and service and access. So those are all the metrics that were required to get in. We did not change our price with the United in order to get into the pervert lab network, nor do we think anybody else did, but we know we definitely did not. So this is really about the total value of the offering. So if you want to go to the best lab with a great price and also have zero out-of-pocket, it's a very simple decision for the patient. So that's important.

There's also in United you should talk about this, but there's also some things that they're doing around in sending physicians as well. So it's not just a patient-driven initiative and I'll let you talk to United about what they're doing on that end.

And then obviously you can imagine we're doing a lot of work in the field with our own commercial sales force to make sure that physicians are aware because this is really good for patients. And most physicians their number one priority is their patient, not their owner, not anybody else, so when they know this was good thing for their patients, they like that. The other thing is it's a source of some patient satisfaction is getting a bill.

And so now you don't have to call to the office about, hey, that lab you ordered from me, I got a bill, I thought it was covered by the office visit, et cetera, et cetera. So reduces noise for the payer, reduces noise for the physician's office, obviously a good thing for us and a good thing for patients.

Steve Rusckowski

Yes I'll just add to what Mark just said, obviously the savings here is zero coinsurance and copayments, but the biggest driver as you're moving through the laboratory that has a significant lower reimbursement rate then if they're working with enough for lab network. So the savings to the consumer is very considerable. But the biggest portion of that has to do with the rate differential, not necessarily with the patient responses they might have or not have with us. So a big opportunity and we're hopeful. As we mentioned it's just getting started this month, it's early. But we're hopeful, this change coupled with the changes that we spoke to take place in 2020 will continue to allow us to grow our presence and our share with United, but also with other payers because we do believe it's a trend overall in the marketplace.

Operator

Our next question comes from Mark Massaro with Canaccord Genuity. Your line is open.

Steve Rusckowski

Hey Mark.

Mark Guinan

Hey Mark.

Mark Massaro

Hey guys, thanks for the question. I guess my first question is for you Mark. Obviously the volume growth is the strongest we've seen in a long time. You talked about the one extra revenue day in the quarter. But you also talked about health plan access with United continuing to build. So can you just give us a sense for whether or not the 5% growth is a level that you think can continue? Can you just give us a little sense of the puts and takes around some of the drivers there?

Mark Guinan

Yes, so we talked about the fact that the about the fact that the extra day net of hurricane Dorian gives about 100 points. So you can kind of take that math in your thinking. Obviously each corner has different puts and takes in terms of the amount of revenue days, and we usually try to be very transparent about how that all plays out. At the beginning of the year we've talked about Q1 having Saturdays and Q3 having an extra day. And obviously next year we have leap year and the quarter's will play out a little bit differently. And we'll give you as much transparency on that as possible. But really when you think about the whole year the next year you're just thinking about generally revenue days are pretty similar year-over-year other than when you have a leap year.

And then we did talk about the capitated volume, which is not impacting the bottom line. But if you're just focused on revenue, at some point next year we laugh that change. So that was about a 100 basis points this quarter. If you recall, we shared about 70 basis points in Q2. So at some point that volume headwind gets behind us.

Now I'll just to share a little additional color in the quarter, our a employer pre-employment testing business is actually a headwind to our growth that was pretty flat. So that's the non-DIS if you remember then about a 20 basis point higher growth rate I shared at the beginning of my prepared remarks for our core clinical business. So we'll see how the pre-employment drug screening business goes, but that was if you want to really think about the clinical business, which is what where we're benefiting from the expanded access and the volume performance is actually slightly stronger than it may have appeared on the surface.

So, is it going to be 5%? Obviously we're not going to have an extra day every quarter. But is it going to continue to be really positive organic revenue growth into the future? Absolutely that's our expectation as we work our way to that fair share I talked about as eventually getting into $1 billion of revenue in these new lives with the three expanded access plans.

Operator

Our next question comes from Eric Coldwell with Baird. Your line is open.

Eric Coldwell

Hey thanks very much.

Mark Guinan

Hey Eric.

Eric Coldwell

At the end of the quarter you have been head on. But I think it's always helpful to get maybe a little more emphatic or explicit commentary. It's all around the M&A and then the capital deployment around M&A. Inorganic growth will really start to abate here in the fourth quarter based on the timing of prior period deals. I'm hoping you can give us some sense on what you're expecting from inorganic growth in 4Q.

Also, you have a long-term model of 2% plus M&A-driven growth. To the extent that the analysts have built in a place holder here, it sounds like we need to be pulling that in for 2020, at least in the beginning of the year. Can you give us a sense on what you would be comfortable with if people have built in a placeholder?

And then third, as you see these elongated decision cycles on M&A cash is building. So are you more comfortable with us leaving that cash on the balance sheet or would you be comfortable with maybe assuming some accelerated repurchase activity as you have those unnecessary balances that start to build? Thanks very much.

Mark Guinan

Yes, so let me go back to our capital deployment strategy. So as we've shared, we're going to do M&A where it's value accretive to our shareholders, there's a clear path. We're not going to do an M&A just to meet some outlooks that we gave. But with that said, we're very confident in that 2% CAGR. So we never include unexecuted M&A in our guidance. So just because we at this point are implying a low level of M&A either in Q4 or early in the next year, doesn't mean that we might not be close to something, but that's just not in our practice. So we don't actually include M&A in our guidance until we have a signed contract, and so on.

So we're very confident in that 2% CAGR. If you look at what we've done, last year and what we're applying this year we're going to be well north of that 2% after two years. We're highly confident that in the next two years to complete that four year CAGR. We're going to be at that level if not beat it, because there is a lot of interest. As Steve shared and as we've talked about these deals have just taken a while it doesn't mean they have fallen by the wayside, we're still working on the same deals that we thought we'd would have gotten done several months ago. But we're very optimistic some of these are going to get completed.

And I'm not going to give you any guidance for 2020. What I'm comfortable with obviously we'll give guidance in late January for the year. I'll talk about the organic M&A mix and then at that point if we have some additional deals that have closed in the interim those will be included. But otherwise we don't typically do that – include that in our guidance.

Operator

Our last question comes from Stephen Baxter with Wolfe Research. Your line is open.

Steve Rusckowski

Hi, Stephen.

Stephen Baxter

Hi, how are you?

Steve Rusckowski

Good.

Stephen Baxter

I want to follow-up on the patient concessions question. So I'm glad you mentioned the Kaiser report. I was flipping through it and it looks like we're seeing a fairly similar trend in this year's report. As discussed at the Investor Day last year in terms of high deductible enrollment, not really increasing that much, but deductibles continuing to march upwards at a similar clip. So I was hoping you could clarify a little bit of what you're seeing in 2019 relative to 2018 in terms of where in the ecosystem you're seeing improvement in collections and your level of visibility into that versus this time last year.

And then finally in terms of quantification, would you be able to give us a sense of what the collections of improvement has contributed to this year's growth? Is it reasonable to think about it as offsetting the United out-of-network impact or should we be thinking about something less than that? Thanks.

Steve Rusckowski

Yes, so at this point we share where our sources of revenue are. And so at this point, patient responsibility is not grown significantly year-over-year. So despite what the Kaiser report is talking about in terms of increased deduction, this year it's not impacted us per se year-over-year. One of the things we did in response to some of the surprise we had last year was we shortened our timeframe. So the way we do our revenue recognition, we're looking at more recent trends that we use to have a longer term trend that worked for us for years, and years and years. So we're looking at a lot more recent, which would allow us to not have surprises like we had last year.

So we've been on top of this. We're very comfortable with what we've been accruing. We're very comfortable with our cash collections. We have a very robust process. And as we look at that we've done better on patient concessions, partially because last year was a particularly poor year for some of the reasons I shared earlier, but part of it is we continue to roll out the tools and partner with Optum, our partner around doing things like offering credit card collections upfront.

We support that with our real-time estimation tool, where if you come into our patient service center, you go to an office where we have an in-office lobotomist. We can tell you on the spot whether the test is covered or not and importantly what your responsibility will be based on that coverage decision and then have an opportunity to say and how would you like to pay for the upfront like most of healthcare has done. So we're collecting more of our cash up front that makes a significant difference in the overall collectability.

We've also seen an improvement in denials. So some of the things we talked about last year, especially in the PBM space where we're surprised by a couple of major payers, I will tell you as I shared earlier, the payers in general continue to throw us curve balls, we're always having to deal with new policy changes, new opportunities for them to deny, but we cleaned up some of the things last year that were more significant. So we've reduced our overall denials in a couple of key test periods. That's helpful.

We've also shared in the past that we continue to get some preferential treatment from a couple of payers where they put in pre-authorization requirements for certain tests and they actually wave that for a couple of labs, including us because they know we do things, right. We don't do excessive testing, we partner with them on what clinically appropriate panels are and approach to testing are. So that not only reduces our denial rate because pre-auth is great challenges for the labs, but it also makes us advantageous for the prescriber because they don't have to worry about pre-auth based on the work to us.

So all of those things together are actually helping revenue growth, and they're helping our overall margin and part of our Invigorate is on the top line. It's not all on costs, some of it is actually getting paid for more of the work we do as Jim Davis has said at multiple Investor Days. So we're seeing good positive improvement in that space.

Shawn Bevec

Okay. Well, we thank everyone for joining us today. We appreciate your support. Have a great day, and talk to you soon.

Operator

Thank you for participating in Quest Diagnostics Third Quarter 2019 Conference Call. A transcript of prepared remarks on this call will be posted later today on Quest Diagnostics' website at www.questdiagnostics.com. A replay of the call may be accessed online at www.questdiagnostics.com/investor or by phone at 888-566-0408 for domestic callers, 402-998-0597 for international callers. Telephone replays will be available from approximately 10:30 a.m. Eastern Time on October 22, 2019, until midnight Eastern Time on November 5, 2019. Goodbye.