Quest Diagnostics (DGX)

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Disclaimers

- I am not a registered investment advisor and I do not offer any investment advise
- No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments

Quest Diagnostics – business

- Diagnostic testing, information, and services (>90% revenues) US-only
  - Network of laboratories and patient service centers;
  - Interpretive consultation to patients and physicians.
  - Commercial clinical testing services, including routine clinical testing for blood chemistries, complete blood cell counts, urinalyses, pregnancy and other prenatal tests, microbiology testing, alcohol and other substance-abuse tests, and allergy tests; cancer diagnostics, such as anatomic pathology services; and gene-based and other esoteric testing, as well as various risk assessment services for insurance companies.
  - Clinical testing to employers for the detection of employee use of drugs-of-abuse
- Hospital-affiliated laboratories 60%, commercial clinical laboratories 33%, physician-office laboratories 7%
- Clients
  - Traditional Medicare and Medicaid Programs 15% - 20% 15% - 20%
  - Physicians, Hospitals, Employers and Other Monthly-Billed Clients 30% - 35% 20% - 25%
  - Health Plans 47% - 52% 47% - 52%
  - Patients 2% - 5% 5% - 10%
- Competition – hospital labs, commercial cos (Laboratory Corporation of America Holdings)

Quest Diagnostics - business (cont'd)

- <10% of revenues and not growing fast
- Develops and manufactures products that enable healthcare professionals to make healthcare diagnoses
  - HerpeSelect ELISA tests that detect patient antibodies to certain types of Herpes Simplex virus
  - White Blood Cell Analyzer
  - InSure fecal immunochemical test for screening for colorectal cancer
- Central laboratory testing for clinical research trials on new drugs, vaccines, and certain medical devices
- Clinical connectivity and data management solutions
  - Care360 suite of products
  - ChartMaxx electronic document management system for hospitals
  - Health information exchange system
- 43000 employees, 900 M.D.s and Ph.D.s

Quest Diagnostics – Misc thoughts

- What can go wrong?
  - Competition? Price war among labs?
- Healthcare reform
  - Positive – expansion of service use
  - Negative – lowered Medicare reimbursements, potential reduction of lab test permissions
- Recession – lower doctor visit #s
- Opportunities:
  - Geographic expansion outside US
  - More tests: gene based esoteric testing, cancer, etc.
  - Economies of scale / single provider

Strategic considerations

- Moat (*switching costs, habit, low cost*):
    - What are the moats? Infrastructure buildout, contracts
    - What does it take to sustain the moats? ??
    - Bargaining power of suppliers/customers? Hospitals/insurance companies have a lot of leverage
- Is it a low risk business? Not very much
- Is there high uncertainty? Somewhat?
- How capital intensive is the business? Moderate to low.
- Future growth – unknown
- Are the revenues and cash flows of the business sustainable or overstated / understated due to boom or bust conditions? Not clear

Management

- I don't usually do management analysis. Included for template completeness
- No dilution
- Can I trust management?
- Management shareholding (> 10%)
- Management incentives?
- Are the salaries too high?
- Is there heavy insider buying?
- Is there heavy insider selling?
- Do I like the management? (Operators, capital allocators, integrity)
- Profitable reinvestment
- What has management done with the cash?
- Where is Free Cash Flow invested? Share buybacks, dividends, reinvested, ROE & ROCE, incremental BV

Is it a good business?

- >10 year history of profits
- ROE:
  - 2007:10.2 2008:16.1 2009:19.1 2010h1: 18.1
- Margins
  - 2008: 8 2009:9.7 2010:9.7
- Growing earnings: 3 year sales growth 3%, earnings growth 28%
- No dilution
- OK balance sheet
  - Cash 500M, debt 3B
- ROIC = Earnings / (Equity + Debt – Cash) = Earnings / (Assets – non-debt liabilities - Cash)
  - 11% ROIC

Is it a good business? Cash flow

- Strong cash flow
  - H1 448M operating cash flow, 360M FCF (FCF = OCF – capital expenditures)
  - Operating cash flow higher than earnings
  - Free Cash Flow/Share higher than dividends paid

Is business cheap? – Buffettology calculations

- ROE 18% - assume 15%
- Earnings in 10 years = ROE*Equity*$(1+ROE)^9$ = $2B
- Equity in 10 years = Equity*$(1+ROE)^9$ = 13.9B
- Market cap = 2B x P/E (15) = $30B
- Rate of return = ~12% after tax (calculations omitted)

- 9 year earnings growth: 25%. Assuming same earnings growth for 10 years into the future and 15 PE at the end, shareprice would grow 28% annually. Assuming 15% earnings growth: 18% share price growth.

Is business cheap? DCF

- Discounted cash flow
  - Current earnings of ~714M
  - 10% growth for 5 years, leveling after that
    - 10% discount -> \$10.7B current valuation (if you buy company at <\$10.7B, you will get 10% return or higher)
    - 15% discount -> \$6.9B current valuation
  - 5% growth for 10 years, leveling after that
    - 15% discount -> \$6.4B current valuation
- Owner's yield = earnings / (market cap + debt - cash) = earnings/EV
  - 714M / (8.5B+3B-.5B) = 6.4%

- What makes up the margin of safety? ??
- Is there a sufficient margin of safety? Maybe

Is business cheap? – Graham investment considerations

- N/A for Quest Diagnostics – included for completeness
- >2 P/Book – not a net net
- Altman Z score (http://en.wikipedia.org/wiki/Altman_Z-score)