Quest Diagnostics (DGX)

Raimondas Lencevicius
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
• 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:
- Margins
- 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