Quest Diagnostics™

TRADITION
INVESTMENT MANAGEMENT

Quest Diagnostics Has Massive Secular Tailwind and Strong Base

Price $149.00 **Dividend Holding** **October 18, 2024**

- 2.0% Yield.
- Strong secular volume tailwind from aging population, with Medicare Advantage holders having a higher average revenue-per-test.
- AI (Artificial Intelligence) in pathology testing should drive high margin growth.
- Tailwind from more bespoke testing, with genetic testing seeing a market-wide spending growth of 8% and 5% volume growth according to Avalon.
- Increasing leverage to 2.5-3.0x debt to EBITDA to enable more freedom in aggressive acquisitions.
- Strong M&A profile, purchasing Canadian provider LifeLabs for $1 billion, which will generate $710 million in additional annual revenues by 2025.

Investment Thesis

Quest Diagnostics (DGX) is a provider of medical diagnostic services to markets across the world. Operations are focused on North America, where DGX has more than 2,000 locations. DGX has extensive coverage over the US population with 90% of insured adults in the US having DGX services covered.

DGX is in an advantageous position to experience a secular volume increase from an aging population. While laboratory testing represents under 5% of healthcare spending in the US, it has massive downstream impacts on healthcare spend. Thus, we expect volumes for lab testing to increase faster than the general economy due to both the secular increase in the average age of the population and the introduction of more bespoke testing, such as genetic testing.

We feel that the core business of diagnostic services provides a strong base with a large secular tailwind. More niche offerings such as consumer-initiated testing and the usage of artificial intelligence in diagnosis could also provide longer-term growth. Currently, DGX offers a 2.0% dividend yield and is authorized to repurchase 6.0% of outstanding shares, which we feel makes it an attractive addition to an income investor's portfolio.

Estimated Fair Value

EFV (Estimated Fair Value) = EFY25 EPS (Earnings Per Share) times P/E (Price/EPS)

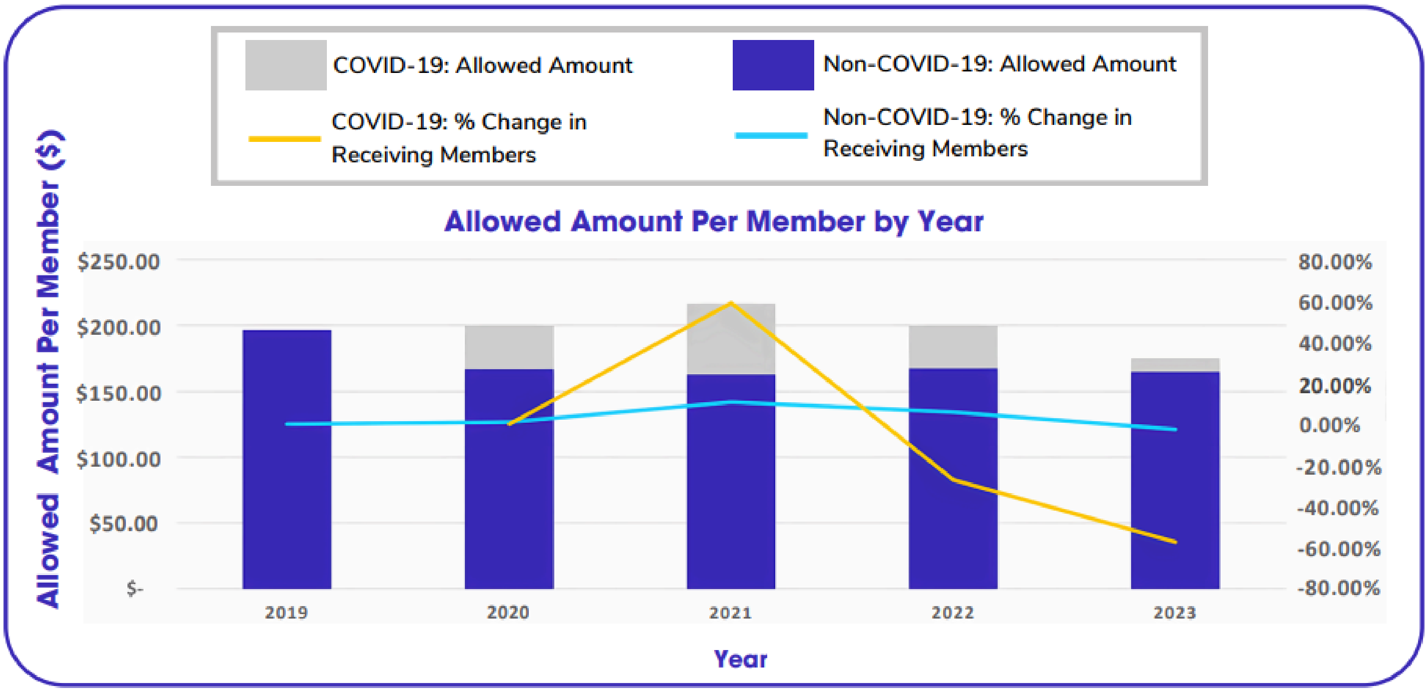
EFV = E25 EPS X P/E = $9.50 X 18.2 = $172.9

We feel that DGX has a secular tailwind from population aging, which will continue to unlock earnings power as time goes on along with its continued M&A actions. DGX expects 3% organic unit growth, and 1-2% growth from M&A activities, therefore we feel that 18.2x reflects DGX's superior market position and strong fundamentals.

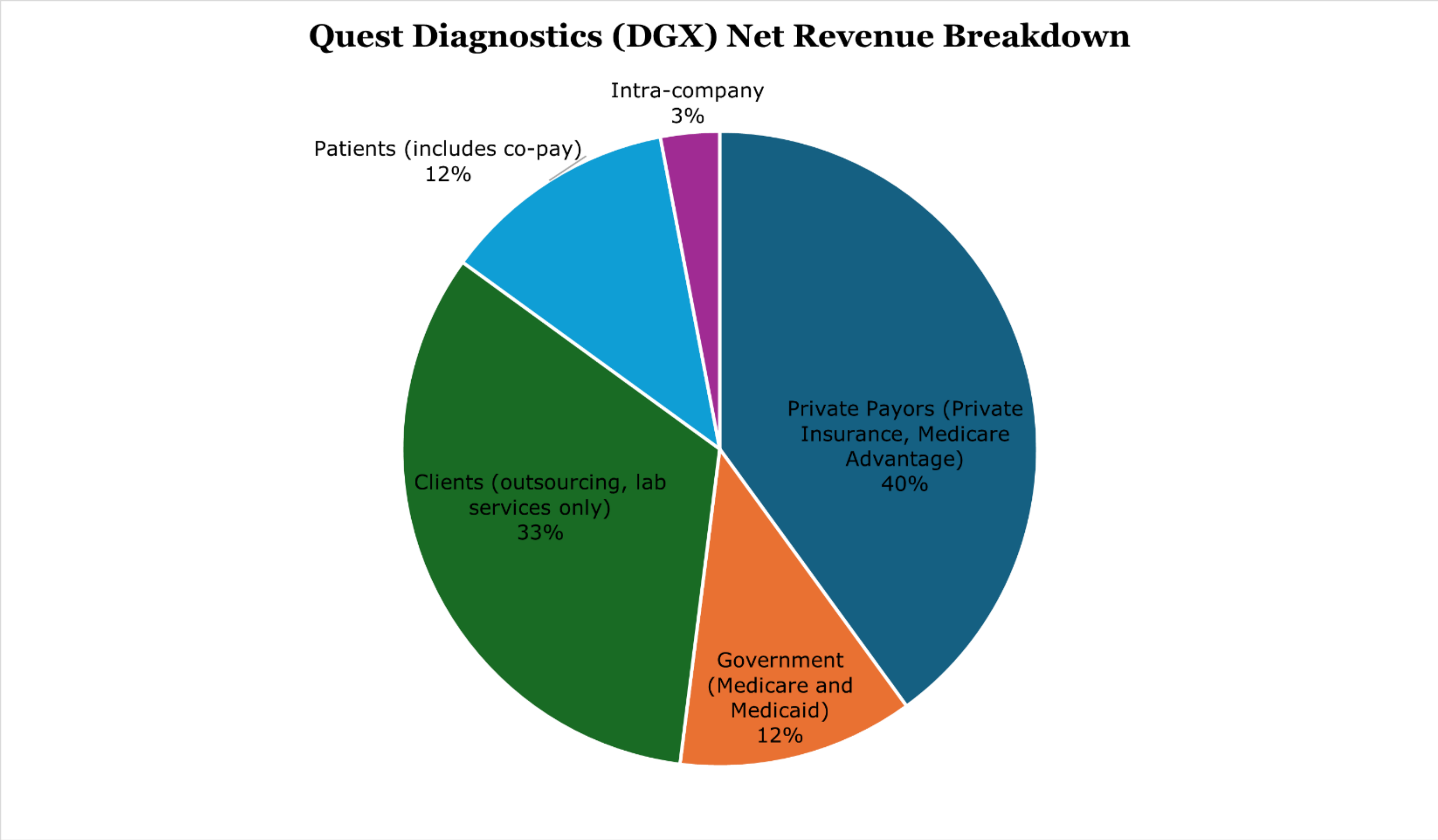
	E2024	E2025	E2026
Price-to-Sales	1.7	1.6	1.6
Price-to-Earnings	16.7	15.4	14.3

Market Conditions and Results

Routine tests like blood panels represent 90% of testing volumes across the US. These routine tests saw a 13% decrease in total spend, in large part due to decreased COVID-19 testing. Overall volumes for routine testing was down 6% for the same reason. Genetic testing saw 8% spending growth and 5% volume growth.



***Reference.** Avalon data on file*



For DGX, full company revenues saw an overall increase of 2.0% for the first half of 2024. Volume was up 1.1% year over year for the quarter ending June 2024, with 0.7% being organic growth and 0.4% coming from M&A activity. Revenue per requisition was up 1.6% year over year, due to an increase in higher margin tests being ordered, such as genetic testing. On a more granular level, the diagnostic business which makes up 97.2% of revenues saw a 2.3% year over year increase in revenues for the first half of 2024. The service business, which makes up under 3%, was down 6.9% year over year. The fall in the service business is largely due to the decrease in the number of pre-coverage screens for both life and health insurance companies.

In 2014, Congress passed PAMA (Protecting Access to Medicare Act) which sought to consolidate multiple fee schedules into a single coherent fee schedule to bring the rates paid by Medicare more in line with market pricing. Every year, labs must report the rates they charge to private payors, which are then weighted by provider size to determine how much every provider will be reimbursed under Medicare Part B. Importantly, PAMA previously had an upper limit on how much the reimbursement could be cut per year. In 2024, the cap is no longer in place, meaning high-volume tests could rapidly decline in reimbursement level. However, this could prove to be positive for DGX in the longer-run, as PAMA disproportionately impacts smaller labs who are forced to take the low-reimbursement rates. In our view, this could lead to further industry consolidation and either allow DGX to expand into attractive markets at a low valuations or effectively limit the scope of competition.

The United States life expectancy has risen steadily since the 1960s, reaching a record 79 years old in 2019. The number of Americans 65 and older will double within the next 40 years to 72 million while reaching an estimated 80 million in retirement age as soon as 2040. According to DGX, those on Medicare Advantage plans tend to have higher revenue per requisition due to higher reimbursement rates from narrower networks and more tests per requisition. As age ramps up, the per-individual spending on items increases drastically, and thus we feel that DGX has a substantial secular tailwind, even if PAMA pricing pressure continues to mount.

Expansion

The largest M&A transaction of the year was a footprint expansion of Canadian provider LifeLabs, estimated to generate $710 million in additional annual revenues, though it will be slightly dilutive to EPS (earnings per share) for the first year. DGX acquired the provider for $1 billion. Because of the Canadian healthcare system's more stable reimbursement profile within a population aging faster than the US, and a potential niche for customer-initiated testing in Canada, we expect this business to grow faster than the US.

DGX is also pivoting to a strategy of acquiring or managing in-hospital or in-clinic labs. According to the CEO, there is a general trend of lab requisitions being given to private labs rather than hospital labs, as patients and insurance companies are much more cost conscious than they were 10 years ago. In-hospital labs have large overhead both due to lower volumes and subsidizing other hospital functions, which cause end-costs to surge by several magnitudes.

M&A activity outside of footprint expansion has focused on diversity of operations, targeting consumer-initiated testing services such as at-home testing kits for common inheritable diseases. The customer-initiated book of business has grown 40% year over year, with half of the growth coming from existing customers, and the other half coming from new customers drawn to new tests introduced during the trailing twelve months.

Another revolutionary tool is AI (artificial intelligence). While most of the media coverage for AI has been on generative AI, the FDA has approved several diagnostic AI models for digital pathology. While patients prefer human-only doctors, pathologists using the technology say it increases their efficiency and accuracy.

In June 2024 DGX completed the partial acquisition of PathAI, using the new acquisition to spearhead DGX's digital pathology business. According to DGX, pathology is less than 5% digitized. Currently, DGX operates 20 pathology centers where collected samples are shipped and reviewed by a pathologist. In digital pathology, instead of the tech shipping the sample to a pathology center for review, digital pathology takes a scan of the sample and sends it remotely to a pathologist or utilizes AI, allowing more diagnostic certainty and access to better quality care. The digitization of pathology to a single location or remote locations eliminates the need for specialized shipping and gives DGX access to new markets without as much startup or regulatory cost.

Equally, we believe this opens the door for outsourced operations, where a hospital digitizes a sample for DGX to review or DGX conducts the sampling for the hospital's pathologist to review. This could offer a high-margin business to increase utilization of lab assets. According to Grand View Research, the digital pathology market is still relatively small at around $1 billion, expected to grow at an 8% CAGR to 2030. But the market is still fragmented, and the rise of cheaper computation and AI have accelerated the pace of growth.

Risk

Larger diagnostic providers, like DGX, tend to have lower reimbursement rates with private payors as private payors are given a volume discount which can skew PAMA data significantly. However, as previously discussed, this could offer some advantages for acquiring smaller providers at a discount, provided regulators do not step in. We feel that the removal of the decrease cap will be delayed given its controversial nature and ongoing legal battle.

A hard labor market with limited hirings has impacted DGX. There are two sides to the problem: the employers that are hiring in the service sector are becoming desperate for low-turnover labor and are thus eliminating a drug screen as a condition for employment. The other side is low hiring rates for skilled professions mean less volume during the downcycle. While we feel that once the upcycle starts part of this volume will recover, the trend of eliminating drug testing as a condition for employment is becoming more common.

Financials

Secularly, DGX expects organic long-term growth of 3%, with an additional 1-2% annually from acquisitions. The pace of M&A has led to short-run dilution, but DGX expects Haystack Oncology (acquired in 2023) to be earnings accretive in 2026 with a positive ROI in 2025 and previously discussed LifeLabs to be accretive sometime in 2026.

DGX reported that wage inflation has moderated, with expectations of a 3-4% increase in wage expenses for the full year 2024 which would be about in-line with expected revenue growth. Turnover is still elevated compared to pre-pandemic, though turnover did decrease to 18% for the first half of 2024. Healthcare continues to be a high turnover and high wage growth industry, though we feel some relief will come if inflation continues to moderate. DGX has a cost-cutting program called 'Invigorate' which it says will deliver around 3% in annual cost savings through consolidation and productivity improvements. EBITDA margin for the quarter ending June 2024 was 20.4%, which is in line with the long-term average.

M&A activity is largely debt-financed and DGX maintains a positive outlook and BBB rating from Fitch. Currently DGX has a debt to EBITDA of 2.1x for the trailing twelve months ended June 2024, which excludes the LifeLabs acquisition. DGX expects the acquisition to push their debt to EBITDA to just over 3.0x and will target 2.5-3.0x on a go forward basis. We believe that despite the higher leverage target and short-run dilutive nature of some of the acquisitions, the strong base provided by its core diagnostic business will easily provide a runway for deleveraging if required.

Capital priorities continue to put M&A and expansion activity at the top spot, with DGX expecting to spend $420 million in capital expenditure for the full year 2024, which we expect to go toward supporting acquisitions.

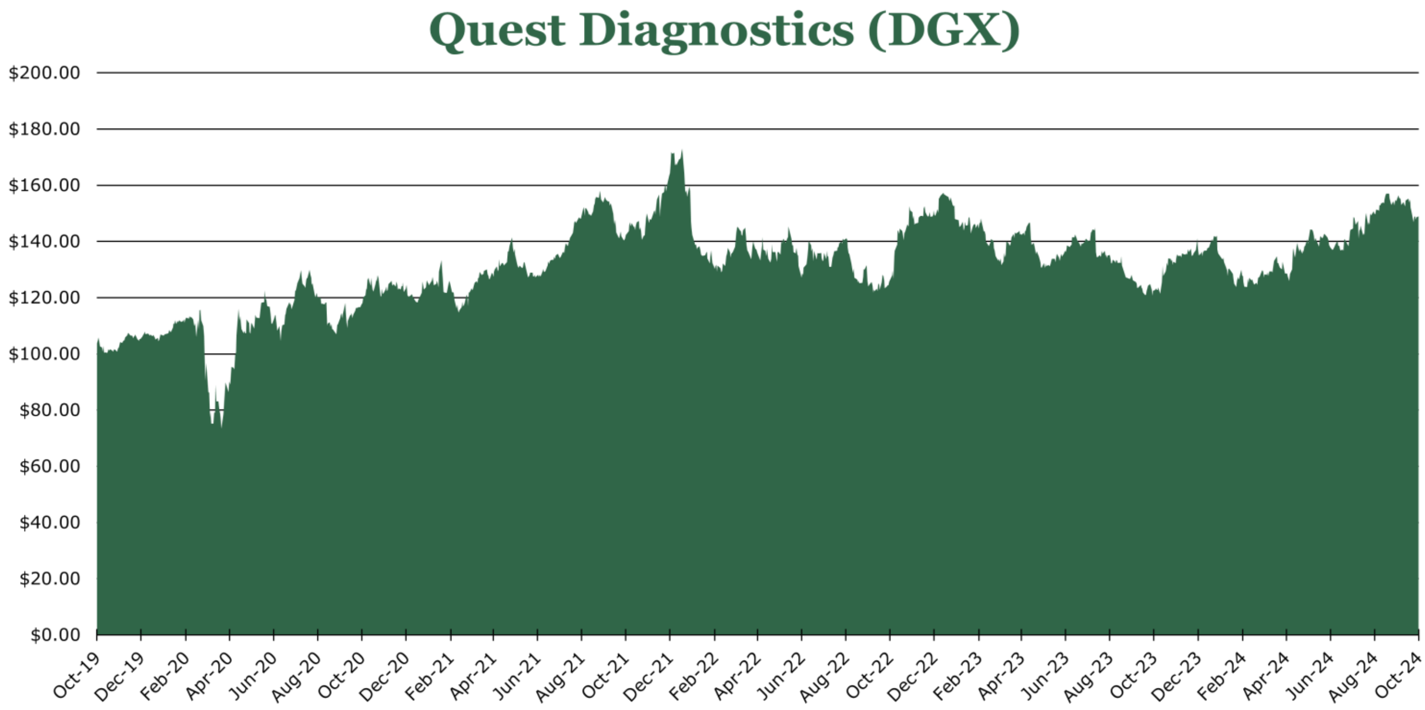
DGX expects to generate just shy of $1 billion in free cash flow for the full year 2024, which we expect to end up being at a similar level to 2023, which was $824 million in free cash flow. Currently DGX has a dividend with a 2.02% yield, which is a payout ratio of around 33%. As of the quarter ending June 2024, DGX has a share repurchase authorization totaling 6.0% of outstanding shares: however, we think that repurchases should be put on the back burner in favor of deleveraging after the LifeLabs acquisition.

Conclusion

On top of a strong M&A funnel, DGX has secular tailwinds in the form of an aging population. DGX offers a safe 2.0% dividend yield and is expected to generate just below $1 billion in free cash per year, going toward both maintaining leverage below 3.0x and repurchasing 6.0% of outstanding shares. Altogether, we feel DGX is an attractive dividend buy with some potential for long-term capital appreciation.

Peer Comparisons

	Quest Diagnostics (DGX)	LabCorp (LH)	DaVita (DVA)	Fresenius Medical Care (FMS)	Chemed (CHE)
Price-to-Earnings	16.71	14.84	16.28	10.25	25.03
Price-to-Sales (TTM)	1.77	1.47	1.14	0.55	3.81
EV-to-EBITDA (FWD)	11.22	10.87	9.94	6.75	17.15
Net Income Margin	8.99%	3.60%	6.86%	2.73%	12.88%
Dividend Yield	2.02%	1.33%	-	3.28%	0.34%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