



New Pricing Strategy Helps Quest, But Rivals Also Get A Little Relief -- Investor's Business Daily

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By Gloria Lau

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It's not often companies can thank a rival for giving them a boost. But that's what's happened in the lab testing business.

Quest Diagnostics Inc., the nation's top lab testing firm, helped the entire industry last year when it strong-armed large managed-care clients into accepting price increases.

Those clients include Aetna Inc. and UnitedHealth Group. They agreed to pay more per lab test analyzed by Quest.

The result of Quest's move was a trend of price increases across the industry this year. Thanks to Quest's efforts, all of its competitors, especially top rival Laboratory Corp. of America Holdings, have been able to boost prices.

The pricing strategy turned into a success. Prices per order at Quest last year jumped 5.8% from a year earlier. They gained another 8% in the first quarter this year.

But another result is that the volume of tests isn't rising as fast as in prior years. That's because Quest's new contracts with managed-care clients aren't exclusive.

"Quest has suffered in terms of volume growth, but that was probably expected," said US Bancorp Piper Jaffray analyst Bill Bonello. "However, Quest can convert low levels of revenue growth into high levels of earnings growth because it has significant economies of scale. That's positive, and critical to success."

Quest's success now rides on whether its sales reps can get clients to send more tests its way and boost Quest's testing volume, Bonello says. Until recently, the company's sales reps had to focus on keeping existing business.

"We've had to focus our sales people on very productively preserving business," said Quest Chief Executive Ken Freeman.

Holding Down The Fort

Part of that is due to Quest's 1999 purchase of its biggest rival, SmithKline Beecham's clinical lab unit. The new company had to work hard at ensuring it didn't lose clients to rivals while it was integrating the two operations.

Now that the two companies are joined, Freeman says, the focus on growth is back. "Now we can put our sales force back at what they do best—selling," he said.

If Quest can continue raising prices at a fast clip, the firm won't have to worry as much about increasing volume, Bonello says. But that's the big question.

"Can they sustain the pricing increases they got in the last 12 months?" Bonello said. "I don't think they can to the same magnitude. So, to grow (the overall company) at the same rate, they'll have to have accelerated volume growth."

Bonello thinks they'll need to get volume growth up to the 6%-plus level for 2002. Right now, volume growth is just 2.5%.

But not all growth has to be organic. It can include acquisitions. Bonello says the company will need to do this over time to sustain companywide growth rates of 25% to 30%.

Freeman counters there's not necessarily a direct correlation between pricing and volume.

"Our guidance moving forward is that we expect prices to improve by 2% to 3% -- it's better to say at the rate of inflation -- and we expect to grow revenue at 5% to 7% a year," he said.

Quest's \$1.3 billion purchase of SmithKline's clinical labs in 1999 gave it enough negotiating power to stop the bullying tactics of its managed-care clients.

"They've been very astute at deciding how to invest their money -- about whether to make it in-house or buy it," said CS First Boston's Andrea Bici.

Unlike many labs at the time, Quest was picky about what contracts it would accept.

"When evaluating contracts (Quest) not only looks at the absolute pricing of specific tests, but also at the service requirements and other cost/benefits related to an account," said Merrill Lynch analyst Tom Gallucci.

Esoteric Growth

Meanwhile, Quest is handling more complex, or "esoteric," tests. This business is growing by 10% a year, a little higher than the overall company's organic growth of 9%.

Gene-based tests, one unit of the esoteric testing business, is growing at an even faster 25% clip. Gene-based tests brought in \$225 million in 2000 sales.

Analysts say these complex tests can be twice as profitable as Quest's commodity tests. Because esoteric tests are less common, hospitals rarely

interpret them in-house because they can't generate enough volume to do it profitably.

But complex tests aren't Quest's only attempt at growing margins.

After 34 years in the business of analyzing lab tests, Quest now has 4 billion lab test results in its data warehouse. And nearly nothing happens in the health care world without a lab result.

In 1997, it formed a medical information business called Informatics. It's still small and brings in just \$20 million to \$30 million a year in sales, Bici estimates.

Doctors, hospitals and others in medicine base medical decisions on lab results. Quest wants them to buy its data to influence the way disease management programs are formed, medical standards are set and pharmaceutical firms market new drugs.

"We maintain the data in a way that's highly confidential and we never share it in a patient-identifiable way," Freeman said.