QUEST DIAGNOSTICS INC
Form DEFA14A
May 04, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of
the Securities Exchange Act of 1934 (Amendment No.)

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o	Preliminary Proxy Statement
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Quest Diagnostics Incorporated

Say-on-Pay Proposal

May 1, 2015

Vote FOR for the Company's Say-on-Pay
Proposal

The Board recommends that the Company's shareholders vote FOR for the Company's 2015 Say-on-Pay Proposal

o The Company's Board of Directors firmly believes that our executive compensation program is designed to pay for performance and aligns the interests of executive officers and the Company's shareholders.

o ISS has recommended that stockholders vote against the Say-on-Pay proposal.

o We strongly disagree with the ISS recommendation, which is not shared by any other proxy advisory firm.

Recent Performance Highlights

We are making good progress on the execution of our five-point strategy and the stock market has recognized this in recent quarters

Restore growth

- We are executing on sales and marketing excellence; growing esoteric testing; and providing professional lab services to hospitals and IDNs
- We have begun to see modest organic growth

Drive operational excellence

- Invigorate delivered more than $200 million in realized savings in 2014 and we exited 2014 with run-rate savings of more than $700 million since the launch of our strategy in late 2012
- We announced a goal to deliver an additional $600 million in run-rate savings as we exit 2017

Simplify the organization

- We restructured our organization to eliminate silos in our core business, provide for leadership in defined geographies and eliminate unnecessary management layers
- In 2014, we introduced the Quest Management System to enhance management discipline and support our efforts to build a high-performance culture

Refocus on diagnostic information services

- Since 2012, we have sold our OralDNA salivary diagnostics business, our HemoCue and Enterix diagnostic products businesses and ibrutinib rights, generating approximately $800 million of proceeds
- We continue to consider options for several other assets, including our products businesses

Deliver disciplined capital deployment

- In 2014, we completed the acquisitions of Solstas Lab Partners and Summit Health; these were targeted transactions aimed at geographical and business line strategic objectives
- In January 2015 we announced that we increased our quarterly common stock dividend by 15%. This represents our fourth increase in the dividend since 2011

Alignment of Executive Compensation Programs

The Company's executive compensation programs are aligned with shareholder interests, our strategy, and pay for performance principles

- Our executive compensation programs* are designed to attract and retain talented executives in a competitive marketplace and to align their interests with those of shareholders.

- The Company's executive pay programs are:

  - A critical component in the Company's execution of its 5-point strategy;

  - Targeted at providing competitive pay opportunities that are performance-based; and

  - Fully aligned with shareholder value creation.

- We reach out annually to large stockholders who collectively own 50%-60% of our stock to conduct executive pay and governance discussions.

  - Based on stockholder preferences we most recently held discussions with stockholders who collectively own 40% of our stock; and

  - We have a track record of taking action based on investor feedback in these areas.

*Appendix A sets out the Company's practices with respect to executive pay.

Overview of Executive Pay Structure

Our executive pay programs emphasize: i) variable over fixed pay, ii) long-term incentives over cash, and iii) the stock price as a measure of performance

Executive Compensation Mix

Base Salary Annual Incentive Target Long-Term Incentives

73% 15% 12% CEO Variable

65% 15% 20% OTHER NAMED EXECUTIVES Variable

o 88% of the CEO's and 80% of other NEO's 2014 direct compensation (base salary, target bonus incentive) was variable, consisting of annual and long-term incentives and linked to performance1

o Our programs provide a competitive pay opportunity: realized compensation can be above or below market based on performance.

o Long-term incentives constitute the bulk of our executives' compensation.

Long-Term Incentive Structure

Long-Term Incentives

20% RSUs 40% Performance Shares %40 Stock Options

Base Salary Annual Incentive Target RSUs Performance Shares Stock Options

o Long-term incentives for our executive officers, which are all equity-based, consist of:

- o 40% performance shares which vest 100% after three years, subject to performance criteri
- o 40% stock options which vest ratably over three years.
- o 20% RSUs which vest 25% after the first year, 25% after two years and 50% after three ye

(1) ISS takes the view that instruments such as executive stock options which vest over time and other aspects of our programs are not performance based. The Company disagrees and we contrast our views with those of ISS throughout the presentation and more specifically in slides 11-15.

Incentive Plan Objectives

Our incentive programs provide line-of-sight to our operating plan, shareholder interests and value creation

over appropriate time horizons

Compensation Vehicle	Strategic Linkages	Time Horizon
Senior Management Incentive Plan ("SMIP")		
Cash Bonus	o Links with annual operating plan o Rewards performance versus goals	One year
Long-Term Incentive Awards ("LTI")		
Performance Shares (40% of LTI)	o Provide strong links with strategy and operating metrics o Performance-based vesting	Three years
Restricted Stock Units (RSUs - 20% of LTI)	o Align executives with shareholders o Balance LTI package o Provide retention incentives	Three years
Stock Options (40% of LTI)	o Align executives with shareholders o Highlight stock price appreciation as a key indicator of success	Ten Years

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SMIP Highlights

Annual incentives are based on performance versus target against key financial and operating goals which are linked to the Company's annual operating plan

o Targets are designed to be challenging yet attainable based on conditions within our segment of the healthcare industry.

o Metrics used by the Company maintain significant weight on financial metrics and can vary to highlight different aspects of our strategy (e.g., doubling the weight on revenues to 40% in 2014 over 2013):

	2013		2014	
	Weight	Payout (%of Target)	Weight	Payout (% of Target)
Adjusted EPS	35%	0%	20%	24%
Revenue attainment	20%	0%	40%	46%
Adjusted operating income	15%	0%	20%	6%
Employee engagement	10%	0%	10%	7%
Other non-financial	20%	10%	10%	12%
Total Payout		10%		95%

o The bonus payouts shown (10% of target in 2013 and 95% in 2014) reflect performance in these periods.

Performance Share Highlights

Performance share metrics and associated weights provide strong linkages with strategic priorities over

successive three-year cycles

Metrics	Weight for Perf. Shares in Cydes Commencing in 2012-14
Revenue Growth	50%
Return on Invested Capital1	50%
Invigorate Run Rate Savings2	
Total	100%

Weight for 2015-17 Performance Share Cycle	Strategic Links
40%	Restore Growth
35%	Restore Growth Drive Operational Excellence Disciplined Capital Deployment
25%	Drive Operation Excellence/Invigorate
100%	

Notes

(1) Return on Invested Capital (ROIC) is defined as Net Operating Profit After Tax (NOPAT) divided by Invested Capital

NOPAT = (Income from continuing operations - net income attributable to non-controlling interests) + Gross interest expense, net of tax.

Invested Capital = Average total stockholders' equity + average total debt (average of the quarterly balances in the year).

(2) Invigorate run rate savings achieved in 2015-2017 inclusive, measured as of 2017 fiscal-year end.

Rigorous Goal Setting/Pay for Performance

Historical SMIP and performance share payouts demonstrate both the rigor exercised in setting goals and

alignment of executive pay with performance

Payout History

Plan Year	SMIP Payout (% of Target)	Performance Share Payout (% of Target)
2005	82	23
2006	148	37
2007	103	127
2008	112	141
2009	129	117
2010	64	33
2011	88	0
2012	72*	2
2013	10	TBD
2014	95	TBD
Average	90	60

*Excludes the annual incentive payments to Mr. Ruschkowski, who joined the Company mid-year and, pursuant to his employment agreement, was paid at a guaranteed level, rather than based on performance.

- From 2010 to 2013, which included some periods of disappointing operating and stock performance, payouts under both the SMIP and performance shares were well below target. In particular:

  - Performance shares for the 3-year performance period ended December 31, 2013 were cancelled without payout, for failure to meet threshold performance (performance measure: CAGR of income from continuing operations); and

  - Performance shares for the 3-year performance period ended December 31, 2014 paid at 2% of target (performance measures: CAGR of revenues (50%) and average ROIC (50%)).

- A review of historical payouts from 2005 to 2014 further demonstrates the degree of rigor in setting goals:

- Our annual incentive bonuses have ranged from 10% of target in 2013 to 148% of target in 2006, averaging 90%.

- Performance share payouts have ranged from 0% of target in 2013 to 141% of target in 2008, averaging 60%.

Shareholder Support and Consistency in Approach

Our shareholders have supported our executive pay programs and our approach has remained consistent, with ongoing actions to improve alignment

Shareholder and Proxy Advisor Support

o Over the past two years, shareholders approved Quest's executive compensation program by an affirmative vote of well over 90%.

o Over the same period, the proxy advisory firms, including ISS, recommended that shareholders support our Say-on-Pay proposal.

o In 2015, both Glass Lewis and Egan Jones are recommending shareholders vote in favor of our executive pay programs, while ISS is recommending a vote against.

Program Consistency & Enhancement

o In 2014, our program remained consistent and we continued to take steps to ensure alignment with shareholder interests.

   o In 2014, for the third consecutive year, we enhanced our senior management stock ownership guidelines, and the minimum shareholding requirement for our CEO is now 6 times base salary;

     o 2014 equity awards require "double trigger" vesting in connection with a change in contr
     eliminated pro-rata vesting upon a voluntary resignation from employment; and

   o For 2014, the Committee also expanded the pool of recipients that received equity awards to more than 200 high-performing employees who historically have not received equity awards, to increase shareholder alignment.

ISS Rationale and Management Response

ISS contends there is a significant disconnect between CEO pay and Total Shareholder Return ("TSR") for 2012-14

o The Compensation Committee regularly reviews alignment between relative TSR and realizable pay and receives advice from its independent consultant, Pay Governance, in these matters.

o In 2014, for the second consecutive year, the CEO's compensation opportunity (base salary, incentive targets and equity award grants) was unchanged.

o The Company's realizable pay for 2012-14 was aligned with the Company's TSR, as shown below:

TSR Percentile Position Vs. Peers	Performance Share Payout (% of Target)
0th %ile/Lowest	2%

Realizable Total Pay Positioning	Assessment
17th %ile	Realizable pay analysis suggest both TSR and pay were in the bottom quartile and were, therefore, aligned

o The ISS conclusion is driven by the ISS methodology*.

(*) The definition of pay used by ISS for their Relative Degree of Alignment test focuses on pay opportunity rather than realizable pay and uses that firm's approach to valuing stock options. Realizable pay takes into account factors such as performance shares actually delivered and the increase/(decrease) in the value of options as the stock appreciates/(depreciates). In contrast, the approach used by ISS values performance shares granted during the performance period at target (100%) even when these expired worthless. The ISS approach also ignores the change in the value of options as the stock price changes and overvalues them vis-a-vis the underlying expense.

ISS Rationale and Management Response
(Continued)

ISS also contends that certain 2014 annual incentive metrics were set at or close to 2013 metrics

o In fact, 2014 targeted modest improvement with respect to target adjusted EPS, despite significant pricing headwinds in our industry.

o Headwinds included persistent declines in revenue per requisition, both at the time the 2014 goals

were set and continuing through 2014:

Table 1: Major Lab Company Revenue per Requisition Trends

	%D 2011-12	%D 2012-13	%D 2013-14
Quest Diagnostics	~0.0%	-3.6%	-1.8%
LabCorp	0.6%	-1.6%	-1.7%

Source: Company filings; figures may include the effect of acquisitions & test mix changes

o Further evidence of the rigor of the 2014 EPS performance goal is how the Company and its closest competitor set adjusted EPS guidance in 2014 versus actual 2013 results and the results that were actually delivered in the year:

Table 2: Major Lab Company EPS Results, Guidance Trends and 2014 TSR

	2013 Adj. EPS	2014 Adj. EPS Guidance	Guidance Midpoint % D Vs. Prior Actual
Quest Diagnostics	$4.00	$3.90-$4.10	0.0%
LabCorp	$6.95	$6.35-$6.65	-6.5%

2014 Actual	YoY % D	2014 TSR*

Adj. EPS		
$4.10	2.5%	28.1%
$6.80	-2.2%	18.1%

(*) Compares with 13.7% TSR for the S&P 500 Index.

Source: Company filings, Bloomberg for 2014 TSR; initial/early 2014 guidance shown; companies may calculate adjusted EPS in different ways; Appendix B sets out GAAP reconciliations of our 2013 and 2014 adjusted EPS results.

o 2014 market outperformance, as shown by relative TSR, clearly indicates market support for the Company's performance.

ISS Rationale and Management Response
(Continued)

ISS also highlighted that our Employee Engagement performance goal in our 2014 annual incentive plan was set at the same level as 2013

- Since 2012, we have been engaged in extensive restructuring of our business operations, involving ongoing reviews of staffing levels and associated job eliminations in many parts of our business.

- Business restructuring, site consolidations, acquisition integrations and health plan changes make it challenging to maintain, much less improve, employee engagement.

  - At the beginning of 2014, the Compensation Committee felt that maintaining the employee engagement level achieved in 2013 - a relatively high level of engagement based on the scale used - would be challenging.

- The fact that the goal was not achieved reinforces the fact that goal was, in fact, challenging.

ISS Rationale and Management Response (Continued)

ISS contends that the majority of executives' equity awards lack performance conditions, which is driven by that firm's view of executive stock options

- Our Compensation Committee disagrees with that view, and believes that options remain an appropriate incentive, fully aligned with shareholder interests.

- Stock options provide long-term incentives to increase shareholder value and only deliver compensation if the stock price increases.

- Options are a particularly useful incentive for the Company in light of its flat stock trajectory over many years prior to 2014.

  - The Committee regularly reviews the use of different instruments (with outside consultants independent from management), after considering shareholder views and market trends; and

  - In 2012, the Committee reduced RSUs, which then constituted one-third of the total long-term incentive, to 20%, while increasing the performance share and stock option components to 40% each.

ISS Rationale and Management Response
(Continued)

ISS contends that the Company's failure to prospectively disclose the targets for the 2014 performance shares makes it impossible to assess the rigor of the goals for these awards

o The Company's practice of not prospectively disclosing the goals for its performance share awards, and instead disclosing the goals at the conclusion of the performance period, is common.

o The Company is concerned about disclosing future, multi-year goals that highlight to competitors confidential aspects of the Company's longer-term strategy.

o The Company has discussed with numerous stockholders over the last few years its approach to disclosure of performance share goals.

o Shareholders have indicated that they understand the Company's rationale for non-disclosure of goals at the time of grant.

o Further, the rigor of the goal-setting for our performance share awards is well documented.

Conclusion

Vote FOR the Advisory Vote to Approve Named Executive Officer Compensation

- Our Board of Directors has demonstrated its commitment to aligning executive pay with performance.

- Our program has a strong foundation and reflects many best practices.

- Our Compensation Committee has taken recent action to strengthen our executive compensation program to foster improved Company performance.

- In 2014, our program successfully aligned pay and performance.

- We strongly disagree with the ISS recommendation regarding the Company's Say-on-Pay proposal.

- Glass Lewis and Egan-Jones both recommended stockholders vote FOR the proposal.

Appendix A - Quest Diagnostics Executive Pay Practices

What we do and don't do

What we do

o Link executive pay to performance

o Maintain a clawback policy that covers both equity and cash incentive awards to current and former executive officers and key employees

o Maintain share ownership and retention guidelines for executives and members of senior management

o Use three-year vesting for equity awards

o Provide for "double trigger" change-in-control vesting in all new equity awards: awards vest following a change in control only if the employee experiences a qualifying termination of employment

o Utilize an independent compensation consultant

o Maintain an investor outreach program to incorporate feedback in our compensation programs

o Annual "say on pay" vote

o Program designed to maximize tax deductibility for the Company

o Evaluate management succession and leadership development efforts

What we don't do

o No excise tax gross-ups upon a change in control

o No supplemental executive retirement plans

o No single-trigger vesting in connection with a change in control for equity awards made after August 2013

o No hedging or pledging or speculative transactions in our securities by directors and executive officers

o No repricing of equity awards without stockholder approval

o No excessive perquisites

o No payment of dividends or dividend equivalents on performance shares

o No vesting schedule that allows full vesting of equity awards prior to the first anniversary of grant (except for 5% of awards) o No encouraging imprudent risk taking

o No employment agreements for executive officers except our CEO

Appendix B - Non-GAAP Reconciliation

Adjusted Diluted EPS

	2014	2013
Diluted earnings per common share	$3.78	$5.31
Gain on sale of ibrutinib royalty rights (a)	-	(1.95)
Restructuring and integration charges (b)	0.53	0.47
Favorable resolution of tax contingencies	(0.30)	-
Loss on sales of Enterix	-	0.17
Other (c)	0.09	-
Adjusted diluted EPS	$4.10	$4.00

Notes:

(a) Represents the gain, net of transaction costs, associated with the sale of the Company's ibrutinib royalty rights.

(b) Represents costs primarily associated with workforce reductions and professional fees incurred in connection with further restructuring and integrating our business.

(c) For the twelve months ended December 31, 2014, represents costs incurred related to legal matters, partially offset by a gain associated with a decrease in the fair value of the contingent consideration accrual associated with the Summit Health acquisition.