



Quest Diagnostics Incorporated

Annual Report 1998

Dedicated people improving the health of patients
through unsurpassed diagnostic insights.

people
patients
insights.



Our Values

Quality

The patient comes first in everything we do. Our passion is to provide every patient and every customer with services and products of uncompromising quality — error free, on time, every time. We do that by dedicating ourselves to the relentless pursuit of excellence in the services we provide.

Integrity

Credibility is the key to our success; therefore, all of our processes, decisions and actions ultimately are driven by integrity. We are honest and forthright in all our dealings with our customers and with each other. We are responsible corporate citizens in the communities we serve. We strictly comply with the laws and regulations governing our business, not only as a legal obligation and a competitive necessity, but because it is the right thing to do.

Innovation

We constantly seek innovative ways to enhance patient care and provide value to our customers. We support the creativity, courage and persistence that transform information into knowledge, and knowledge into insights. We seek continuous advancement through the adaptation of existing knowledge as well as through experimentation, with the full understanding that we learn from our failures as well as our successes.

Accountability

As a company and as individuals, we accept full responsibility for our performance and acknowledge our accountability for the ultimate outcome of all that we do. We strive for continuous improvement, believing that competence, reliability, and rigorous adherence to process discipline are the keys to excellence.

Collaboration

We believe in teamwork and the limitless possibilities of collaborative energy. We achieve excellence by putting collective goals ahead of personal interests. We support and encourage open communication and meaningful cooperation among colleagues from varying backgrounds and disciplines. We respect individual differences, and we value diversity.

Leadership

We strive to be the best at what we do — both as a company, and as individuals. We embrace the qualities of personal leadership — courage, competence, confidence and a passion for surpassing expectations. We will provide growth opportunities for our employees, quality services and products to our customers and superior returns to our shareholders.

Our Business:

Quest Diagnostics Incorporated is one of the nation's leading providers of diagnostic testing, information and services with laboratories and patient service centers across the United States. The wide variety of tests performed on human tissue and fluids help doctors and hospitals diagnose, treat and monitor disease. Nichols Institute conducts research, specializes in esoteric testing using genetic screening and other advanced technologies, and manufactures and distributes diagnostic test kits and instruments. Quest Informatics collects and analyzes laboratory, pharmaceutical and other data to help large health care customers identify and monitor patients who are at-risk for certain diseases.

financial highlights

	Y E A R S E N D E D D E C E M B E R 3 1	
(in millions, except per share data)	1 9 9 8	1 9 9 7
Net revenues	\$ 1,458.6	\$ 1,528.7
Net income (loss) before restructuring and other non-recurring charges	26.9	17.6
Net income (loss) (a)	26.9	(22.3)
Weighted average common shares outstanding – diluted	30.2	29.2
Diluted net income per common share	\$ 0.89	\$ (0.77)
Adjusted EBITDA (b)	\$ 158.6	\$ 153.8

(a)

Includes non-recurring charges totaling \$56 million in 1997.

(b)

Adjusted EBITDA represents income (loss) before income taxes, net interest expense, depreciation, amortization and restructuring and other non-recurring charges.

By most measures, 1998 was a year in which your company made solid progress. Even as we met the challenges of growing competition and declining clinical testing volume, we generated strong cash flow, extended our strategic partnerships in new and innovative ways, aggressively managed costs, and made significant progress toward achieving our goal of becoming a unified, customer-driven company with common systems, practices and values everywhere throughout the country. At yearend, we were well positioned to take a new strategic step to further improve our prospects.

Perhaps most important for long-term success, we reinforced in 1998 the commitment to our vision – “dedicated people improving the health of patients through unsurpassed diagnostic insights” – by pledging ourselves to a set of ambitious and clearly quantifiable goals for instilling unsurpassed quality in every aspect of the business.

As the information included in this report demonstrates, Quest Diagnostics has come a long, long way from the difficult years of the mid-1990s. Our turnaround is succeeding. We are committed to becoming the clear industry leader by providing our patients and customers with services and products of exceptional quality. In a business where the quality of what we do can literally mean the difference between life and death, we are absolutely convinced that consistent, unsurpassed quality will provide the ultimate competitive edge.

SBCL Acquisition

We announced an agreement as this report was going to press to acquire

the clinical laboratory business of SmithKline Beecham plc. Quest Diagnostics has agreed to purchase SmithKline Beecham Clinical Laboratories (SBCL) for approximately \$1.3 billion in cash and stock. This important acquisition will enable us to provide a higher level of service for customers and patients in a cost-constrained environment, thereby increasing shareholder returns.

This transaction is highly strategic and timely. We are confident we have the discipline and the focus to ensure successful integration of the two companies. We are acquiring a company that in many ways mirrors our own business. Both companies have strong reputations as well-managed operations. We share a common commitment to quality, integrity and compliance, and are both dedicated to improving patient health. Combining the two companies will improve the quality, convenience and accessibility of our services; accelerate innovation of new tests and information products; and enable continued reduction in our costs by sharing the best practices from each of our organizations. We expect to complete the transaction this summer, following shareholder approval and regulatory clearance. Upon completion, SmithKline Beecham plc will become our largest shareholder, owning approximately 29.5% of our shares.

Performance Summary

We are pleased to report that in 1998, Quest Diagnostics reported net income of \$26.9 million, or \$0.89 per diluted share, on revenues of \$1.46 billion, versus 1997 net income, adjusted to exclude special charges, of \$17.6 million, or \$0.60 per share, on revenues of \$1.53 billion.

As anticipated, requisition volume declined 7% from 1997, although the rate of decline did slow over the course of the year. Given these conditions, we are particularly pleased with our ability to generate substantial amounts of cash. We ended the year with \$203 million of cash on hand, and generated \$141 million in cash from operations. Strong cash generation reflects significant improvements in our billing, collection and cost management processes.

There are many other indicators of financial strength in our 1998 performance:

In addition to repaying \$33 million of scheduled bank debt, we prepaid an additional \$20 million of debt ahead of schedule, while also buying back \$13 million of our stock.

We remained firmly on track to meet the commitment made at the time of our spinoff from Corning Incorporated in early 1997 to reduce the cost of running our business by \$180 million by the end of 2000. Through the end of 1998, we eliminated \$100 million in costs unrelated to the decline in requisition volume, and we remain confident that we will meet our goal. These savings are allowing us to reinvest in our business to assure long term profitable growth.

We reduced bad debt expense from 7.4% of revenues in 1997 to 6.1% in 1998, steadily progressing toward our goal of 4% by the end of 2000. A major step was the conversion of our Teterboro facility to a new billing system, by far the largest and most successful conversion to date.

We saw average revenue per requisition increase for the second consecutive year, following five straight years of declines. Partly, this was a result of replacing low-profit business with higher-profit business as we demonstrated our steadfast commitment to provide services only to those customers from whom we are properly compensated, even if that means a decline in volume.

We made substantial progress during 1998 toward addressing the Year 2000 computer-programming problem. Although substantial work remains, we are on track to complete the first phase on schedule midway through 1999, which will leave the second half of the year for testing and refinements. Consequently, we fully expect core systems to be Year 2000-ready before the end of the year. Our Year 2000 work has provided the added benefit of accelerating efforts to standardize billing and laboratory systems across the country.

Nevertheless, 1998 was not without disappointments. Our progress toward standardization of systems and practices was significant, but not as swift as we had hoped. Also, the joint venture in Arizona, Sonora Quest Laboratories, in which we hold a minority interest, encountered significant integration challenges that hindered its first year of operations. Also, Nichols Institute Diagnostics, our medical products subsidiary, encountered startup losses associated with the introduction of its state-of-the-art Nichols Advantage instrument.

Finally, the decline in the volume of test requisitions was disappointing. Admittedly, the rate of decline

slowed in the second half; moreover, of the 7% year-over-year decline in volume, about half was directly attributable to our own consolidation of facilities and to our decision to reduce unprofitable business. Still, we do not intend to shrink our way to success, and we continue to pursue top line growth through the strategic acquisition of SBCL and the active development of new high growth businesses.

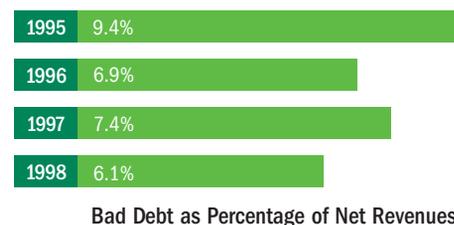
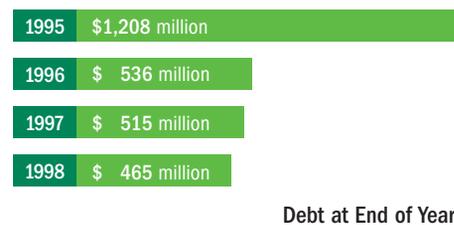
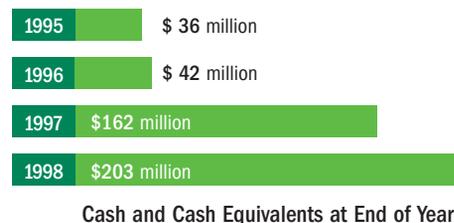
Strategic Partnerships

Your company intensified efforts to become the preferred partner with large buyers of health care services. We made important inroads within the highly competitive field of hospital testing, which accounts for nearly 55% of the \$30-plus billion market in clinical testing. In part, our success comes from viewing traditional competitors as potential partners, and providing ways we can profitably work together to reduce their lab testing costs while simultaneously improving quality.

Over time, we have come to realize there is no “one-size-fits-all” model of collaboration; each situation is unique and requires creative approaches, ranging from outsourcing routine testing to fully integrated joint ventures. Some of the partnerships successfully established in 1998 include:

Joint ventures with UPMC Health System in western Pennsylvania and Unity Health in St. Louis, both leading hospital network and health care providers in their respective regions;

Partnerships through which we provide multiple clinical services to



*Adjusted EBITDA; excludes restructuring charge and other special charges

the highly regarded hospitals of the Johns Hopkins Health System in Maryland and Sutter Health Systems in California. During the year we established or renewed long-term supply arrangements with more than 100 hospitals and hospital systems;

A long-term contract with Oxford Health Plans to manage a network of laboratory service providers, as well as provide lab services, for its 1.75 million members. We will provide network management services using QuestNet, an innovative new product developed during the past year; and

A partnership with Premier Inc., a leading group purchasing organization for hospitals, through which Quest Diagnostics obtained an exclusive 10-year contract to provide strategic services for Premier members and affiliates.

Historically, our primary avenue into the hospital testing market has been the highly specialized esoteric testing provided by our Nichols Institute. We are proud that in 1998 Nichols Institute became the first clinical laboratory in North America to receive ISO 9001 Certification. This internationally recognized standard of quality encompasses the management and document control systems for design, development and performance of diagnostic lab testing, information and services. Other Quest Diagnostics labs are pursuing certification, and we are intent on replicating Nichols Institute's success throughout our company. Indeed, that achievement helped set the tone for the company-wide emphasis on quality excellence that was reinvigorated in the fall

and will be our primary focus in the new year.

Our Quality Journey

We began "Our Quality Journey" by establishing some exceptionally ambitious quality challenges that we fully intend to meet by the end of 2002. The only way we can achieve them is through a fundamentally different approach to doing business based on quality excellence – through education and training in the principles of quality management, through rigorous process discipline, and through performance-based compensation linked directly to our company-wide goals. Here is what we have set out to accomplish:

Improve Employee Satisfaction:

Our goal is to reduce voluntary employee turnover from almost 16% to 10% in 2000 and 7% by the end of 2002. We estimate that voluntary turnover is costing our company at least \$60 million each year in terms of recruitment, training and inefficient operations. Increased retention will have a significant impact on the quality of our work and our success at managing expenses.

Improve Customer Satisfaction:

Each quarter, we survey our customers to determine their level of satisfaction with our service. For the past four years, our results have improved, but only marginally.

Using benchmarks and measures provided by outside specialists, we have set specific numerical goals for improvement for each of the next four years. The bottom line: Satisfactory is not acceptable. We intend to become the benchmark for quality in our industry.

Achieve Six Sigma Medical Quality:

The ultimate measure of our service to customers and clients is the accuracy of our medical test results and reports. Generally speaking, our industry has been comfortable with an accuracy rate above 90%. We have established a new goal of Six Sigma– an accuracy rate of 99.99966% or only 3.4 errors per million – which approaches error-free testing and reporting. We fully intend to become the first in our industry to achieve this goal.

Deliver Bottom Line Growth:

Our goal is to more than double operating profit (EBITA) by 2002. That means we must continue to remove costs while restoring profitable growth to the top line.

These four goals are interrelated. We must achieve the first three: increased employee satisfaction, greater customer satisfaction, and dramatically improved medical quality, to enable us to meet the financial goal.

To help us accelerate growth and improve organizational effectiveness, we made two senior-level appointments in January. We added a distinguished health care industry veteran, Dr. Surya Mohapatra, as Senior Vice President and Chief Operating Officer. In this new position, Surya, who comes to us after nearly 18 years at Picker International, will be responsible for all facets of our core clinical laboratory testing business. In addition, Jim Chambers has accepted a new assignment as Senior Vice President and Chief Growth Officer. He will lead the integration of SBCL and Quest Diagnostics, while continuing to spearhead our efforts to grow beyond our traditional business.

Meeting the Challenges of 1999

The four quality challenges represent an ambitious agenda. We are fully committed to meeting these new challenges, while continuing to build on the initiatives that gained momentum in 1998.

During 1999:

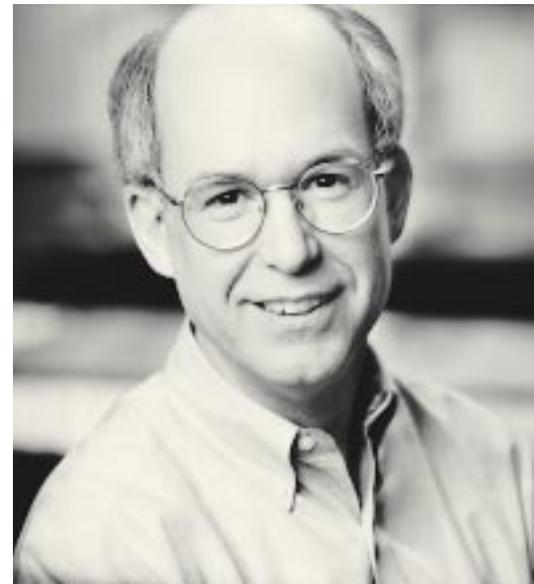
- We will begin the process of bringing Quest Diagnostics and SBCL together;
- We will maintain and intensify our efforts to standardize practices, policies and priorities across the company;
- We will continue to manage costs aggressively;
- We will complete preparations to ensure our information technology systems are Year 2000-ready;
- Despite a difficult environment characterized by ever-changing government regulations and requirements, we remain committed to maintaining our status as the industry leader in compliance;
- We will maintain our focus on raising revenue per requisition by providing higher value to cost-sensitive customers in a highly fragmented, competitive environment;
- We will continue to seek out profitable partnerships with large buyers of health services as we pursue new growth opportunities to offset continuing declines in our traditional markets; and

- We will reestablish top line growth at Quest Diagnostics and continue strong cash generation.

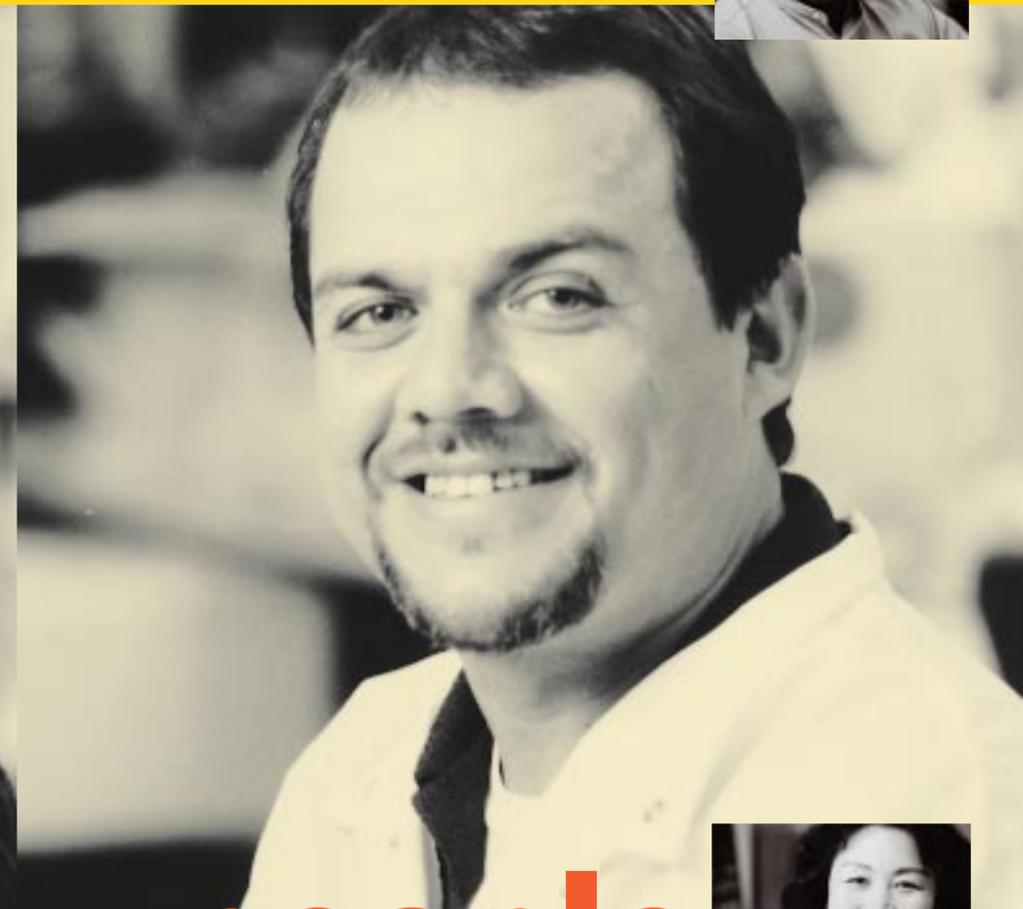
In short, 1999 promises a year full of challenges for your company, but one in which we have the opportunity to move far beyond the solid record of accomplishments we have established during our first two years as a public company. We are convinced that our attention is focused on the right goals: providing quality services for our customers and patients, an exceptional working environment for our dedicated employees, and a strong return on our shareholders' investment. By maintaining an unswerving focus on these critical areas, we can look forward to reporting another year of strong performance improvement in the new year.



Kenneth W. Freeman
Chairman and Chief Executive Officer



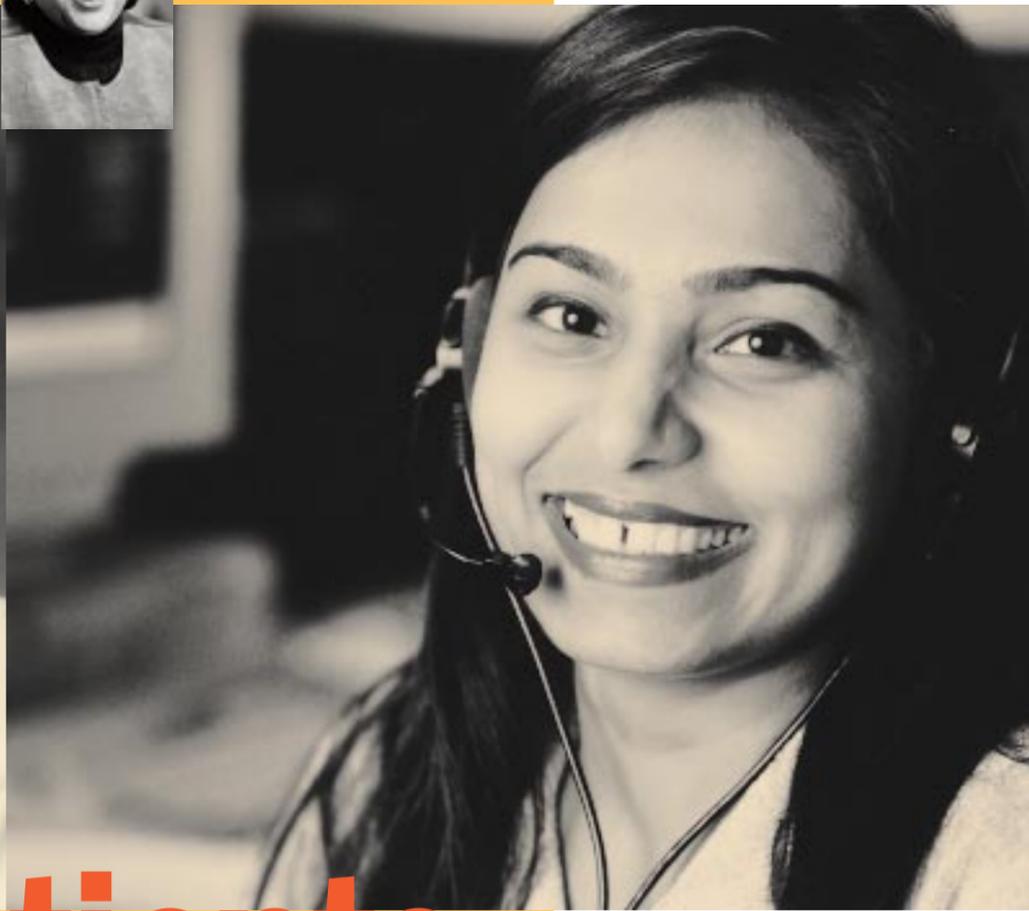
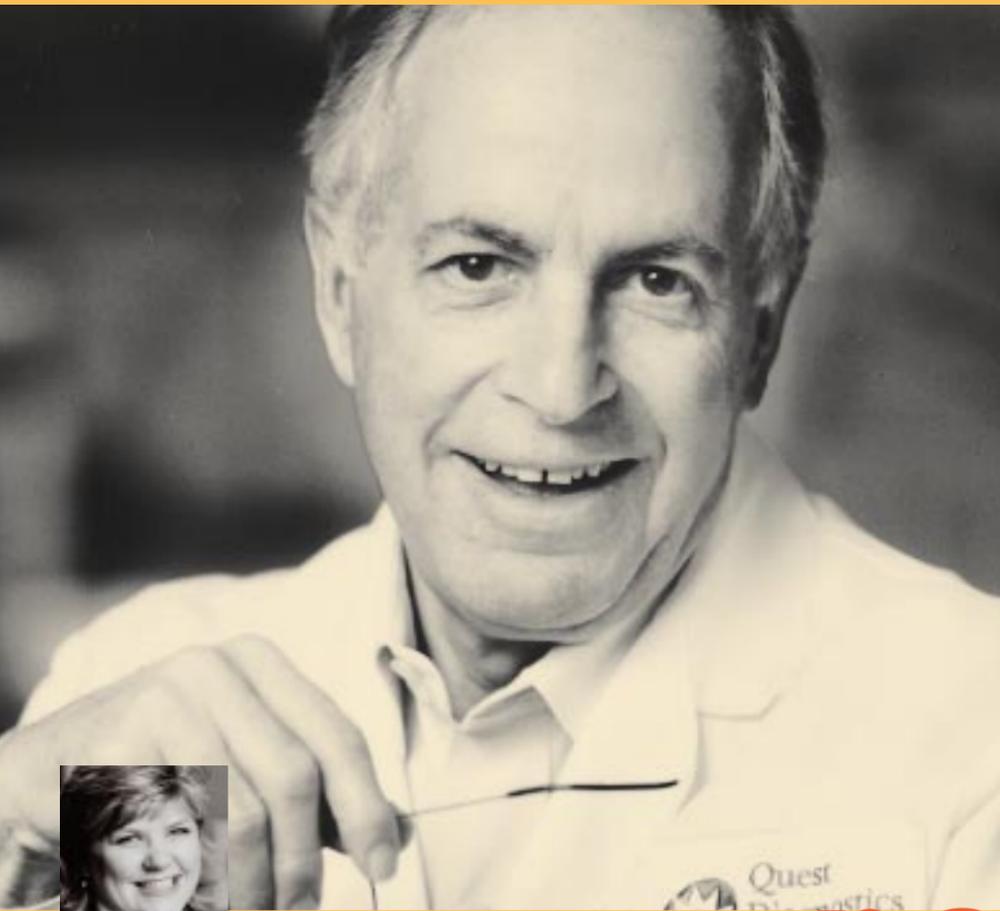
The 15,000 employees of Quest Diagnostics are our most valuable resource. Across the country, every day, they put their hearts and souls into their work. Why? They know that every time they collect a specimen, transport it to one of our laboratories, perform testing or report the results back to a physician, someone's life may depend on the job they do. During the 1980s and early 1990s, our company grew through acquisitions. Employees came from many predecessor companies. Today, they are all building a common company-wide culture at Quest Diagnostics, based on shared values and best practices, with a single-minded focus on quality that starts with understanding our customers' expectations. For many of our employees, it is not enough merely to help patients during work hours. Our national volunteer program, called "reach!" (remember every act can help), enables our employees to contribute to the communities in which they live and work, thereby helping to improve the lives of those who use our services every day.



dedicated **people**



Clockwise, from top: Mervat Ayad, Cytogenetics Laboratory Manager, Nichols Institute; Brian Wade, Systems Analyst, Clinical Studies Center, San Juan Capistrano; Jose Martinez, Customer Service Rep, Nichols Institute; Joan Zou, Forensic Certifier, San Diego; Nina Green, Operations Leader, San Diego; Maria Ortega, Project Manager, Lab Operations, Teterboro; Phil McGill, Shipping and Receiving Supervisor, San Diego; Clarence Johnson, Courier, Denver; Estela Comba, Lab Support Supervisor, Nichols Institute; and Sylvia Harrison, Courier, San Diego.



improving the health of

patients



Most medical care decisions simply are not made without laboratory test results. The thousands of different clinical tests we perform help doctors and large health care organizations diagnose, treat and monitor the health of patients. In 1998, some of the biggest buyers of health care services entrusted their patients to our care—household names like Johns Hopkins Health System, Oxford Health Plans, Premier Inc., Sutter Health, Unity Health and UPMC Health System (formerly University of Pittsburgh Medical Center). Why did these demanding customers partner with Quest Diagnostics? First and foremost, because they have confidence that our quality is second to none. (It is no coincidence that our Nichols Institute was the first laboratory in North America to receive ISO 9001 quality process certification.) Our expert medical staff is on call for consultations to help treating physicians diagnose their most difficult cases—24 hours a day, 365 days a year. Our courier service helps hospital partners reduce overall turnaround time for outpatient testing, giving doctors and their patients precious time to consider more treatment options. Every patient expects and deserves the best medical care. Quest Diagnostics provides a vital link.

Clockwise, from top: Ellen Simonson, Customer Service Technical Representative, Denver; Jayshri Kapadia, Client Services, Teterboro; Tess Eusebio, Clinical Toxicology Supervisor, Teterboro; Ralph J. Partridge, Jr., Inventory Control Clerk, Billing Data Entry, Horsham; Amy Verrinder, Sales Support Specialist, San Diego; Raymond Gambino, M.D., Chief Medical Officer Emeritus, Teterboro; Brenda Ellison, Data Entry Operator, Histology, Horsham.

Knowledge plus experience yields insights. We offer insights that improve patient care in a variety of ways. At the world-renowned Nichols Institute, our specialty laboratory and research and development center, insights emerge from our review of a steady stream of cases that are rarely seen anywhere else. Nichols Institute is the “laboratory’s laboratory,” drawing unusual cases not only from Quest Diagnostics’ own network, but also from hospital labs and other independent labs. At Quest Informatics, insights come from our ability to detect patterns in vast databases containing hundreds of millions of ordinary test results. Managed care providers and pharmaceutical companies use this valuable information resource to identify patients at risk for certain diseases for early treatment. Our insights enable us to help bring patients the benefits of new technology. Since the 1970s, Nichols Institute has been a leader in tests for breast tumor markers—tests not only to diagnose disease, but to help physicians manage therapy by predicting a patient’s response to a given treatment. In 1998, Quest Diagnostics became the first national laboratory to offer the HercepTest assay, approved by the FDA to identify women who are likely to benefit from Herceptin, a new monoclonal antibody therapy for metastatic breast cancer developed by Genentech, Inc.



through unsurpassed diagnostic **insights**



Clockwise, from top: Michael Samoszuk, M.D., Medical & Scientific Director, Oncology, Nichols Institute; Michael Lewinski, Ph.D., Scientific Director, Infectious Diseases, Nichols Institute; Delbert Fisher, M.D., Chief Science Officer, Nichols Institute; Avelino Diao, Molecular Microbiology Lab Supervisor, Nichols Institute Reference Laboratory; Raj Pandian, Ph.D., Science Leader, Nichols Institute Reference Laboratory; Scott Todd, Human Resources Manager, Nichols Institute; Salli Schwartz, Supervisor, Referral Testing, Horsham; Geoffrey Gottlieb, M.D., Dermatopathologist, Teterboro; and Candice Miller, Quest Informatics Business Leader.

Board of Directors

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Washington, District of Columbia

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Vice Chairman
Xerox Corporation
Stamford, Connecticut

Van C. Campbell
Vice Chairman
Corning Incorporated
Corning, New York

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Managing Director
Bankers Trust Company
New York, New York

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Chairman and
Chief Executive Officer
Quest Diagnostics Incorporated
Teterboro, New Jersey

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President of Bell Laboratories,
Executive Vice President and
Chief Operating Officer
Lucent Technologies Incorporated
Murray Hill, New Jersey

Gail R. Wilensky, Ph.D.
John M. Olin Senior Fellow
Project HOPE
Bethesda, Maryland

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Chairman and
Chief Executive Officer

Surya N. Mohapatra, Ph.D.
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Chief Operating Officer

James D. Chambers
Senior Vice President
Chief Growth Officer

Gerald C. Marrone
Senior Vice President
Chief Information Officer

Kurt R. Fischer
Vice President
Human Resources

Robert A. Hagemann
Vice President
Chief Financial Officer

Bernard L. Kasten, M.D.
Vice President
Chief Laboratory Officer

Raymond C. Marier
Vice President
General Counsel

C. Kim McCarthy
Vice President
Government Relations and Services

Alister W. Reynolds
Vice President
Strategic Planning

Paul J. Traina
Vice President
Compliance

David M. Zewe
Vice President
Sales

Major Facilities

Regional Laboratories:

San Diego, California
Wallingford, Connecticut
Denver, Colorado
Deerfield Beach, Florida
Wood Dale, Illinois
Baltimore, Maryland
Cambridge, Massachusetts
Auburn Hills, Michigan
Lincoln, Nebraska
Teterboro, New Jersey
Portland, Oregon
Horsham, Pennsylvania
Pittsburgh, Pennsylvania
Irving, Texas

Nichols Institute

San Juan Capistrano, California

Nichols Institute Diagnostics

San Juan Capistrano, California

Patient Service Centers located across the United States

*For the center nearest you, please call:
1-800-225-7483 or visit our web site:
www.questdiagnostics.com*

Affiliated Equity Ventures

(% ownership):

Associated Clinical Laboratories (54%)

Erie, Pennsylvania
Partners: Hamot Health
Foundation, Saint Vincent Health
Center

Quest Diagnostics Venture LLC (51%)

Pittsburgh, Pennsylvania
Partner: UPMC Health System
(formerly known as University of
Pittsburgh Medical Center)

Quest Diagnostics of Missouri LLC (51%)

St. Louis, Missouri
Partner: Unity Health

Sonora Quest Laboratories LLC (49%)

Phoenix, Arizona
Partner: Samaritan Health System

National Imaging Associates (27%)

Saddle River, New Jersey

Home Access Health Corporation (13%)

Hoffman Estates, Illinois

Investor Information

Common Stock

Shares in Quest Diagnostics Incorporated (ticker symbol: "DGX") are listed on the New York Stock Exchange. Options on Quest Diagnostics shares are traded on the Chicago Board Options Exchange.

Corporate Headquarters
One Malcolm Avenue
Teterboro, New Jersey 07608
Telephone: 201-393-5000

Annual Meeting

The next annual meeting of shareholders is scheduled to be held in late June, 1999 in New York City. A proxy statement is expected to be mailed to shareholders during May, 1999.

Additional Information

All inquiries should be addressed to: Investor Relations Department
Quest Diagnostics Incorporated
One Malcolm Avenue
Teterboro, New Jersey 07608
Telephone: 201-393-5030

Annual Report on Form 10-K

A copy of the Quest Diagnostics 1998 Annual Report on Form 10-K, filed with the Securities and Exchange Commission, is contained in this Annual Report, starting after page 14. Additional copies are available without charge by contacting the Investor Relations Department.

Internet Access

Corporate news releases, our annual report, Forms 10-K and 10-Q and other information about the company are available through Quest Diagnostics' web site on the Internet:
<http://www.questdiagnostics.com>

Transfer Agent and Registrar

Harris Trust and Savings Bank
311 West Monroe Street
Chicago, Illinois 60606
Telephone: 312-461-6001

For the hearing impaired, Harris Bank has a Telecommunications Device for the Deaf (TDD) telephone. The listing is Harris Bank Hearing Impaired Telephone: TDD 312-461-5633.

Report change of address to Harris Bank at the above address.

Quest Diagnostics does not pay any dividends on common stock.

'Safe Harbor' Statement under the Private Securities Litigation Reform Act of 1995

The statements in this Annual Report which are not historical facts or information are forward-looking statements. These forward-looking statements involve risks and uncertainties that could cause the outcome to be materially different. Certain of these risks and uncertainties are listed in the 1998 Form 10-K Annual Report. These risks and uncertainties include heightened competition, impact of changes in payor mix, adverse actions by governmental and other third-party payors, the impact upon Quest Diagnostics' collection rates or general or administrative expenses resulting from compliance with Medicare administrative policies, adverse results from pending governmental investigations, reduction in tests ordered by existing customers, material increases in premiums for insurance coverage, denial of licensure, computer or other system failures, development of technologies that substantially alter the practice of medicine and changes in interest rates.

Compliance

Quest Diagnostics is committed to the highest ethical standards and complying with all applicable laws and regulations that govern its business operations, including those that apply to reimbursement for testing under the federal Medicare and Medicaid programs.

Quest Diagnostics requires that all employees abide by these laws, rules and regulations and provides annual compliance training for all employees. Quest Diagnostics is committed to protecting the health and safety of its employees as well as the environmental resources of the communities in which it operates.

The Raymond Gambino Quality Award

The purpose of the Raymond Gambino Quality Award is to encourage and recognize quality excellence within Quest Diagnostics. The award is named for Quest Diagnostics' distinguished Chief Medical Officer Emeritus whose long career includes service as Director of Laboratories and Chief Pathologist at St. Luke's-Roosevelt Hospital in New York City as well as a tenured professorship of pathology at the Columbia University College of Physicians and Surgeons.

1998 Recipients:

Denver, Colorado
Horsham, Pennsylvania
San Diego, California

1998 Challenger:

Cambridge, Massachusetts

Trademarks

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HercepTest is a trademark of Dako Corporation. Herceptin is a trademark of Genentech, Inc.

Neither this report nor any statement contained herein is furnished in connection with any offering of securities or for the purpose of promoting or influencing the sale of securities.



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