by Randall Rothenberg

Photograph by Peter Gregoire

Kenneth W. Freeman: The Thought Leader Interview

The founding chairman and CEO of Quest Diagnostics identifies the five stages of a turnaround.

In business, transformation has become the rage. Securities analysts tout companies that have successfully transformed. Publications — *strategy+business* included — dissect the elements of transformations. A growing library of management books (including several praised in this, our annual "Best Business Books" issue) provide transformation rules and lessons. But the fact is, the confluence of foresight, ability, and timing that results in a business transformation is a rare event.

Kenneth W. Freeman has run — and won — this trifecta. As the founding chairman and chief executive officer of Quest Diagnostics, he took a battered firm, spun off in 1996 from a distant corporate owner, and made it the eighth-fastest-growing earnings engine in the United States, according to *Fortune* magazine. During a five-year period ending in 2003, Quest Diagnostics delivered profit growth of more than 56 percent annually. During the same span, Quest shares appreciated 730 percent, the second-highest percentage gain among all S&P 500 companies. Although its growth was certainly abetted by a

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series of strategic mergers, an enormous part of the company's success derived from the re-creation of its culture.

"I wanted to take a company that was hostile and hierarchical, and not particularly disciplined, and create a values-oriented, honest, disciplined company where the people respected each other," Mr. Freeman says. "I had to model the behavior at the grass-roots level."

Most readers have been, quite literally, touched by Quest Diagnostics, which is based in Teterboro, N.J. Quest Diagnostics was originally cobbled together by Corning, the glass company, from several hundred acquisitions during the 1980s and early '90s. Under Mr. Freeman's stewardship, today Quest Diagnostics is the largest medical testing firm in the world, with 37,000 employees performing tests on 130 million patients annually, for about half the hospitals and physicians in the U.S.

Quest Diagnostics' recent transition to new leadership has been as exceptional as its evolution from chaos to growth. Only three years into its spun-off life, Mr. Freeman identified and began grooming his successor, Surya N. Mohapatra. Having passed the CEO title to Dr. Mohapatra earlier this year, Mr. Freeman, now 54, will relinquish the chairmanship to him this December. A few months before the scheduled handover, *s+b* editor-in-chief Randall Rothenberg sat down with Mr. Freeman in a modest conference room in Quest Diagnostics' New York satellite office to learn how to execute a transformation.

S+B: It's rare that a chief executive gets to create a company consciously. Most of the time, origins are buried in history, or you're an entrepreneur too consumed with day-to-day business to think about culture and organization. But you were dwelling on this from day one.

FREEMAN: We had to get the hearts and minds of the employees — to give them something to believe in, to help them understand whom they were working for, to understand their role, to take ownership for what they had to get done, and to feel excitement about what the company could become.

S+B: Why was there such a lack of identity?

FREEMAN: Quest Diagnostics evolved from Corning, which since 1851 was primarily a glass and ceramics company. But by 1982, Corning was tired of being so cyclical, and was looking to diversify into services. They had done some things in medical products, which had gotten the company access to hospitals and diagnostic testing laboratories. So the senior leadership said, "Why don't we buy one of these labs we sell all these instruments to?"

They did, and then proceeded to start rolling up the industry. There were about 5,000 mom-and-pop labs out there, with average revenues of a few million dollars. By 1995, Corning Clinical Labs had become one of the three largest labs in the country, all of which were about the same size — about a billion and a half in revenue. At that time, the total U.S. market was probably about $30 billion.

S+B: That initial consolidation didn't "take" well?

FREEMAN: Corning treated the lab business in a very autonomous manner. That autonomy carried through to how the folks who were running the business on the ground in Teterboro would run what they acquired.

S+B: How well did that work?

FREEMAN: When I arrived at Corning Clinical, we were in the news, but not for the right reasons. We were paying fines to the federal government related to Medicare billing. Our customers were unhappy. Our employees weren't happy to be where they were. And virtually none of them knew the name of the company. They remembered the name of the company they worked for before being acquired.

S+B: How did you get tapped to do the turnaround?

FREEMAN: I was a longtime Corning person, since 1972. I was the controller of the company in the mid-'80s. Then into the '90s, I started running turnarounds. I ran the television glass business for a while.

S+B: How, if at all, did finance prepare you for general management?

FREEMAN: The numbers give you an important scorecard for how business is performing. If you understand the balance sheet, how revenues are generated, what the cost structure looks like, and how it all interacts to yield cash flow, it gives you important tools to be able to make decisions that, hopefully, will help maximize the value for shareholders.

The flip side is, finance doesn't really prepare you for the flood of different kinds of decisions all coming at you at once, which you have to choose between as a general manager or CEO. Today, am I going to spend all my time worrying about contracting with our largest customer, or deciding whether to build or shut facilities, or meeting with employees?

What I remember most about the shift from finance to general management was how I felt. In finance, a staff job, I'd have highs and lows, but they'd be smooth, like a gentle wave. A good day might be, "I gave some good advice today, and a senior person took the advice." You get into the line, you're running a business, you're accountable, and it's a monsoon of emotion, big highs, big lows.

S+B: Did Corning Clinical Labs look like a normal turnaround?

FREEMAN: It quickly became crystal clear that it wasn't a business that just needed a few tweaks on the radio dial. Everything wasn't working. All the financial measures were negative, and in the first 60 days, we took a $60 million write-off in the billing area, which was big for us at the time. Ultimately, about a year after I arrived, May of '96, I got the call from Corning that said, "We're going to spin you off."

S+B: Why, personally, take the leap into running such a problem company, rather than return to Corning?

FREEMAN: Why? I love a challenge. And I felt it was fixable. I believe that virtually any business in a three-year time period can be turned around, and sustainably. And here you've got a business that is in health care. It's doing lab testing. As people get older, they need more of it. There was no technology "gotcha" on the horizon at that point that would have said this industry is going to be completely transformed, like going from landlines to cellular phones. And there was overcapacity in the industry. There was a lack of pricing discipline. There were opportunities to grow. What was needed was a focus on the basics of conducting business, a focus on values, process discipline, and execution.

Survival Strategy

S+B: When did those opportunities crystallize into a strategy?

FREEMAN: The first strategy was to survive, because we were broke. But right on its heels came driving to leadership. There were three big competitors in the industry, all roughly the same size, and thousands of smaller local competitors; all of us were beating our heads against the wall with the same customers.

S+B: But your earliest moves weren't really about the market. They were about the people.

FREEMAN: You have to establish your credibility. One thing I faced going in the door was people in the company saying, "Who is this 'glass guy' from Corning, coming to us with no lab experience? He has no health-care experience to speak of. He's not a 'laboratorian.'" At the time, we had 14,000 employees. I reached to the bottom to reach up, to establish my credibility first with the rank and file of the company.

I started visiting our laboratories. One of the first was in Pittsburgh. And I said to the general manager and his staff, "Look, I'd like to take a walk around the lab." They were puzzled. "We can show you the equipment," they said. I said, "I don't want to see the equipment. I want to meet your people."

What I learned was that the general managers didn't know their employees by name — who they were, why they came to work. So the CEO had to model the behavior we needed going forward, or change would not happen. I wanted to take a company that was hostile and hierarchical, and not particularly values oriented, and create a values-oriented, honest company where the people respected each other and were responsible for their actions. I had to model the behavior at the grass-roots level. And if I hadn't done it, no one would have. Creating change in a troubled company must start at the top. The CEO sets the tone.

S+B: To whom specifically did you reach out?

FREEMAN: There were many groups of people who really touched our customers. Couriers, customer service reps, phlebotomists.

S+B: What are phlebotomists?

FREEMAN: They're the people who draw the specimen. The blood. About 60 percent of the blood drawn for our tests is done in hospitals or doctors' offices. The rest is drawn by our phlebotomists. In our industry, that's one of those places where the rubber meets the road, because they have that direct contact with the patient.

S+B: Was the reaching out done primarily through those walking tours?

FREEMAN: It was a concerted effort across a whole bunch of areas. The company was a bunch of fiefdoms all running their own shows. There was no way to get information to or from the field. There were no metrics. We couldn't tell our daily cash balance. We didn't know how many employees we had. We didn't have a voice-mail system.

So I put in a comprehensive communication approach. I created a leadership forum, made up of the top 60 people of the company at the time, that met monthly to teach and drive the changes needed. I put in an employee hotline with direct access to me. You could send me an e-mail anytime, day or night, and I would respond within 24 to 48 hours. The entire company had the opportunity to participate in setting the values and the vision for Quest Diagnostics when we were spun off.

S+B: Is there a distinction between values and vision?

FREEMAN: Vision and identity, in a way, are what you do, and the values and culture are who you are and how you work. You need both. But if you can't create a view of what your identity is for employees, it's hard for them to kind of figure out how their behaviors are going to fit in. By our engaging the employees, it became crystal clear the kinds of things we all had to establish. Integrity. Quality. Accountability.

Metrics and Incentives

S+B: How did you encourage alignment?

FREEMAN: We created metrics and incentives that rewarded desired behaviors. All employees had previously been on a profit-sharing plan that had no credibility. We put in place measures where the people could see, understand, and touch the numbers on a regular basis. It wasn't just working on goals that the senior management would identify, like what are our earnings per share, but it would be something that people could own and influence. For example, one of the things we had learned was that it took an average of over two minutes to answer the phones in customer service and billing. We set a goal of becoming "world class," which meant answering the phone in 20 seconds. And then we set a payout stream, 0 to 2x on this component.

Not every person can touch everything. Not everybody drives answering the phone in customer service. But we identified enough different areas that you, as an employee, could touch and feel, and say, "I can make a difference" — from reducing missed pickups to improving turnaround time. None of this is rocket science, absolutely none of it. It's very practical, down-to-earth stuff.

The business had historically been run to satisfy shareholders only. If you're working to satisfy shareholders only, and don't put your primary energy into satisfying

> **"I wanted to take a company that was hostile and hierarchical, and create a values-oriented company."**

your customers and employees, what happens? You're focused on short-term results. In virtually any company, if you live to maximize short-term results, there is a good chance you won't create sustainable long-term performance.

S+B: What was the cultural impact?
FREEMAN: Our employee attrition rate when I arrived at the company was 25 percent. Today, our overall attrition rate is in the zone of 10 percent, which is much more typical of a large health-care services provider. And our employee satisfaction survey results have improved dramatically.

Turnaround Stages

S+B: When did you stop using the word *turnaround* in the company?
FREEMAN: Let me draw the arc. I think of five stages. The first stage is to "stop the bleeding." The second stage is "stability," where the business is predictable — a smooth pond, no wind — earnings aren't improving, but they aren't falling either. The third stage is "gradual improvement." That's when a light appears at the end of the tunnel. And it doesn't have to be a very bright light: "Gee, we improved our earnings by 1 percent," or "we took our average time to answer the phone from two minutes to one." The fourth stage is "rapid improvement"; that's really where, as an established company, you always want to be — where things are clicking, the financial and nonfinancial metrics are all moving in the right direction. You're achieving or exceeding your targets, and you're really making things happen.

The fifth stage I call "sustain the gains." It's a tricky one, a real problem. It's when people in companies start believing their own press, thinking they're great and talking about it, when arrogance sets in. And arrogance is the biggest enemy I know of for any company. It's the beginning of the bleeding stage. As a company, you have to work to get into the rapid improvement stage, and then figure out a way to stay there.

S+B: So your goal as a leader is to breed a slightly neurotic underdog?
FREEMAN: You have to be. If I, as CEO, don't go to bed every night thinking somebody is going to try to beat me in the marketplace the next morning, something is wrong with me. Although we've gone from stage one to stage four, and have been in stage four now for five years, we can never let up.

Integration Rules

S+B: When you're making acquisitions, what are you actually buying?
FREEMAN: People.

S+B: Employees or customers?
FREEMAN: Both. You're really buying relationships with customers as well as talented people who can make it go.

S+B: You don't think of it as buying a functional area or buying a novel test.
FREEMAN: Not usually, although we've made a couple of acquisitions to get information technology that would take too long for us to build internally.

S+B: Can you boil down merger integration into a set of principles?
FREEMAN: Oh yes. Rule No. 1, customers will be served without disruption; don't do anything to the systems or the processes without making sure the customer is taken care of. Rule No. 2, treat every

employee with fairness, dignity, and respect. Traditionally, what would happen when labs would come together was that half the people would be fired. They wouldn't be treated well on their way out. And people who were survivors, of course, would see what had happened to the folks who lost their jobs. The third rule is deliberate speed: Wall Street says go fast, get me the synergies. You can't always follow the Street. Don't go too fast, and don't go too slow. And the last rule, learn from each other — no winners, no losers.

S+B: How do you realize rules like that?

FREEMAN: When we acquired our biggest competitor, SmithKline Beecham Clinical Laboratories, in 1999, we put everybody through an education process about the four ground rules, followed by the all-important enforcement of the rules. The acquisition more than doubled the size of the company, from $1.5 billion to $3.2 billion. Every part of the combined company was going to have to undergo a change. I ran a selection process where all 200 senior leaders had to undergo an independent assessment, to provide unbiased information that would help me decide who would get the top jobs.

S+B: Did your existing leadership team pass the test?

FREEMAN: Some did, some didn't. That was one of the first tangible signals that there would be no "winners" and no "losers" due to one's prior affiliation. And did it cause some ripples in the company!

S+B: You also identified your successor at about this time — only three years after spinning the company off.

FREEMAN: I believe that CEOs generally stay in their jobs too long, to the detriment of shareholders. The SmithKline acquisition and the leadership evaluation helped set up the process to identify the successor. Essentially, two people came through who I thought potentially could be CEO. One was the person who made it, Surya Mohapatra.

S+B: Mohapatra is a Ph.D., a scientist — a very different background from yours. Is that reflective of the strategic evolution you foresaw?

FREEMAN: It was an important element. I saw that there would be a time when medical science and technology would drive our company's growth. I'm the arts, he's the sciences. I play the piano and he reads research papers. He's got patents. He's been in health care for 20 years. He understands the technologies and can go toe-to-toe with the doctors and research scientists.

Much of our future growth will be from innovative new tests and techniques and information technology. As we've evolved, we've had lots of people coming to us, startups and established companies. "Here's the latest test to identify people at risk for colon cancer or a heart attack or stroke." And so, the needs in the senior leadership generally, and the CEO role specifically, are changing. If I found somebody who was just like me, I don't think it would be the right skill set or the best skill set to take the company forward.

Open Innovation

S+B: So innovation is the key to future growth?

FREEMAN: Innovation is very important, but the bedrock will always be quality and service. Because in the end, technology can be replicated. We've got 130 million patient encounters a year. All we have to do is screw it up — not only in the testing, but in billing or any other encounter people have with us. If the noise gets loud enough at the managed-care companies or the physicians' offices, they'll walk away. Part of the simplicity of this business is that, if you can excel in quality and service, it will differentiate you from your competitors.

S+B: Where, then, will technology have the greatest impact?

FREEMAN: An area where there is the potential for differentiation in terms of technology that will drive growth, even more so than new tests, is information technology. Because, in the end, we're really an information company. So the ability to provide information to physicians and, ultimately, to the patient that helps lead to better health-care decisions is part of how this company has evolved.

In health care, you've got lab results. You've got imaging results. And you've got the conversation with the doctor. Those are the three basic sources of information from which health-care decisions are made. The opportunity to have a medical record that's uniquely yours, that you transport with you, whether it's on a CD or whether it's ultimately an implanted chip, is the future of this business.

That kind of chronological, unique, always available information has never been used in health care. It represents a significant opportunity for our business. ✚

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