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Interview with Michael Danzi
U.S. Labs

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MICHAEL DANZI

The Early Years

I was born on the edge of the Sahara Desert in Libya outside of Tripoli. My father was a career Air Force officer. We grew up mostly overseas, and then came to the United States before I started high school. My grandfather had more of an entrepreneurial background. He was an immigrant who began working at a very young age, at the age of ten. He started delivering newspapers for the owner of a print shop. By the time my grandfather was forty, he bought the print shop and ran it for over thirty years. He sold it when he was in his seventies and actually continued to work in the business until he passed away in his nineties. Because we moved so often, I got to visit him about every two or three years. And visiting the print shop was always the highlight of the trips back to see him in New York. A lot of the culture in my family was about the change in lifestyle once he bought the print shop and what a difference it was to be the owner instead of an employee. So, although I grew up in a fairly big company culture, with my father being in the Air Force, the influence of my grandfather, I think, was profound on my early interest in running my own company. I'm also the oldest of five children, so I was always in charge, which may be part of why I'm comfortable in the role I'm in now.

My experience in the Navy was extremely valuable to me on a number of levels as well. I had an engineering degree from Cornell, and to pay for Cornell, I had a full scholarship from the Navy. After college, I was fortunate to be selected to go into the nuclear Navy where I got advanced training in nuclear engineering. I was then very fortunate to be selected for a program that they are now writing books about, a very secret, very classified, very exciting program for a young guy, to be able to do what we did in the Cold War in the early 1980s. The captain of my ship was a man by the name of Archie Clemens, who went on to become a four-star admiral and commander in chief of the Pacific Fleet. I learned a great deal working for him. I learned a lot about integrity; one of his big messages was not only can there be no impropriety, there can be no appearance of impropriety. And he ran a tight ship, with a keen grasp of the details, but also was a strategic thinker. There's a real limit on what I'm allowed to say about what we did, but we were on very dangerous missions sailing in harm's way and in very stressful environments, extremely stressful environments. We were very highly rewarded, in terms of medals, and we worked directly for the president. I got to go back and brief the Senate Intelligence Committee once; that was very interesting. So I recommend the book, *Blind Man's Bluff*. The middle chapters are about a program that we were involved in.

Archie Clemens was also a big believer in training and in building people up. And as I look at what's happened with U.S. Labs–we're going to make a lot of money, and that's important, it's important to our investors, it's important to me personally–the greatest satisfaction that I receive out of this company is the people that we've built up and trained over time. And to see them reach their potential has been very rewarding. A big part of my job is to be a coach and a mentor to these people. The flip side is that it's extremely disappointing when it doesn't work out and you have to fire people, kick them off the team, but that's a lesson I learned in the Navy. The other lesson I learned is tenacity. At the end of submarine school, after nearly a year of very rigorous and grueling training, and they keep beating into you that you're not contributing, you need to get through this and get out. But at the end of submarine school, this old admiral came in. He was droning on and on about all kinds of things, and he finally caught himself and realized he had lost us. He said, "All right. There's one thing I want you to remember: Don't give up the ship." And he walked off the stage. And it got my attention. It was so hokey, but it got my attention.

I remember distinctly the first casualty on the submarine when I was a young ensign. We had a fire in one of the scrubbers, and I was the first guy on the scene. Your temptation is to get away. You're in danger, there's a fire, and I realized that there was nowhere else to go, we were hundreds of feet under water, far from shore, and there was no one else who was going to put this fire out except for me. That was a lesson that has stayed with me for a very long time, because there were many other casualties on the submarine, many other tough situations, many tough situations in the company, and because "it's not over till it's over" and "don't give up the ship," and because tenacity really matters and the world steps aside for someone who knows where they're going. If you keep strong, people will follow you through hell and back. And as Winston Churchill said, "If you're going through hell, keep going" and that's the way to get through it.

The HBS Experience

Because my father had been in the service, that's all I really knew. I had done well in the Navy too and it gave me some great opportunities. But I had wanted to go to Harvard since I was a child because having grown up overseas it was one of the few schools I had heard of. Now I just had this desire to go to the Business School.
I got accepted to Harvard while I was in the Indian Ocean. I decided that having a Harvard MBA was not necessarily an advantage in the Navy so I realized I'd probably be leaving the Navy if I went to HBS. And I really enjoyed my time on the submarine, but I was married and my wife very much wanted me out of the service. So it was a family decision, but it was actually a hard decision.

For me, having a transition from engineering and the military and going to Harvard was instrumental in my ability to transition into the real world. I had lunch the other day with a woman who's very successful in business and she had been married to an Air Force pilot who couldn't make the transition. She said it was a disaster for him. I have other friends who left the Navy and then ended up going back in because it was too difficult a transition for them. I really credit HBS with giving me the tools I needed to make the transition. I had never even heard of things like investment banking and consulting before I showed up at Harvard. I'd never taken an accounting course or any of that.

The biggest eye-opener, though, was taking organizational behavior. Coming from a tight team, like on a submarine, where you know everybody and you trust everyone, to go in and learn about how organizations work was shocking. It took me a long time before I could crack a case in OB, but it was very educational for me. We were doing one case and we were talking about hiring a very talented person and moving him up through the ranks and training him. I remember this one very sharp guy in my section said that if this person is that smart, you need to get rid of him, because he wants your job, which is a thought that had never, ever occurred to me, ever. And to see that fully half the class agreed with that position was an eye-opener for me.

At U.S. Labs, we aggressively try to hire junior military officers and military people because we believe they bring a lot of positive traits to business, but I also see the transition for them and it's tough. I credit my Harvard experience as allowing me to make that transition. It wasn't perfect, but it sure helped a lot. I feel a lot of gratitude that I was able to go to Harvard.

Early Career

I had never heard of investment banking or consulting before HBS, but as we liked to say in the mid-1980s, I looked at every job opportunity there was–I looked at consulting and investment banking. I went to consulting. I worked at McKinsey & Co. for the summer. At the time, Drexel was changing and Mike Milken was changing the world. This was just before the scandals Mike faced. There was a very high-profile job and I was very fortunate to be selected for it. They only picked a couple of us and I got to go directly to L.A.; it was exciting. Harvard had prepared me for this. Before HBS, I knew nothing about finance, but I took the advanced corporate finance classes at the school. I showed up fully equipped to do the job, fully equipped. Actually, there were a couple of Stanford and other MBAs, but it was clear that the training at Harvard was dramatically better than the other schools. Dramatically.

I went into the corporate finance side. It was very interesting, very exciting, with tremendous deal flow, and it actually led to my interest in entrepreneurship. I was doing a number of transactions ranging from a $1 billion workout of a nuclear facility–they picked me because I was used to going through protestors to go to work–to a $10 million IPO for a company that a very fine gentleman had started, built up over a lifetime, and was taking public. The emotion and the passion that came from him and his team were dramatically different from what I'd seen on some of the larger deals where you'd say, well if this doesn't happen, what are you going to do? Oh, I don't care, I'll go get a job somewhere else. I started migrating toward doing some of the smaller deals while I was at Drexel, in part because of the passion, and in part because I had more say. As a junior person I was given a lot more latitude on deals like that. That really helped fire me up. It helped define my position that I did not want to be in a large company. I wanted to be involved with something smaller.

Eventually, at the age of twenty-eight, I left Drexel and bought a company in San Diego. It was hard to leave Drexel. They're good people and it was a great opportunity, and I left before things really blew up there, but I wanted to run something. So I did a leveraged buy-out and, boy, that did not go very well. It was a tough industry. I did all the Porter analysis, all the competitive strategy analysis, but I missed a few major points. The guy selling it was desperate and he had kind of cooked the books a little bit. So we had a little problem with the company. We ended up divesting it, selling off some pieces, and it was not a real win for me, it was not a win at all. I learned a lesson that if somebody wants to cheat you, they're going to get away with it, that people are willing to change books and get their accountants to do things, and it was a very difficult process for me. And it may sound arrogant, but I had never failed at anything before that. I had set goals and I had hit them my entire life, and this was a real kick in the teeth for me. I came out of it alive, my family was intact–I had a daughter by then–and the only solace I got was when I remembered reading somewhere that most entrepreneurs fail three times before they're successful. So I figured that this was just a step in the path to where I was headed. I think we got out of it with a minimum of pain to anybody. Nobody lost money except for me, and I just kind of brushed myself off and went back into banking.

I then started my own investment bank in southern California and really focused on one-off venture capital deals. In southern California from the '90s on, healthcare has been very big, biotech's big, and so is biomed. And so I ended up getting some investors to invest in a company called Biotech Solutions. This was in the early '90s, and a couple of really brilliant Ph.D.'s out of UC Santa Barbara had come up with an idea to automate the process of applying monoclonal antibodies to cancer tumors, which previous to that had been done at academic institutions. It had been a very difficult process, sometimes involving up to 100 steps and it was very hard to maintain and to do with any kind of regularity and repetition. That was impeding its use as a technology. There were other things happening in the market as well. There were new technologies to take very small biopsies, particularly for breast cancer, but traditional chemical assays couldn't read them anymore. There was this major shift towards smaller and smaller biopsies and the need to analyze them with these new advanced tests using antibodies. So the technology was at the right place at the right time, and we started investing in it.

The company, Biotech, made a very large piece of equipment to automate this process. We had a competitor and we were just killing each other in the marketplace, because we were all going after the early adopters who were, of course, playing us off against each other. We got to the point where we were at breakeven and had invested a lot of money. We were doing about $10 million in revenue. Our competitor was doing about $10 million, they were losing money, and we decided to merge. But it was like two drunks holding each other up. We merged in February of ’96 and by July the market was terrible. We went public with over $200 million market cap. So everybody won; it was a big win for everybody. And I remained on the Board of Directors throughout that process and afterwards.

Finding the Opportunity

Having been now in that industry for four plus years and having made a lot of customer calls, I understood what was going on in this whole cancer market. I was sitting at a board meeting and I realized that while we were on the equipment side of the business, being the customer who used the equipment could be a very good business. I felt that there were opportunities to improve and different ways to approach the market. So with that in mind–I had a non-compete with my old company at that point–I went to them and said, “Here’s what I’m thinking. I would like to do this.” They mulled it over for a while. Their question was, “Are you really going to compete with us?” Instead, U.S. Labs is now one of their largest customers. So that was the opportunity, to get out of equipment and get onto the services side, which brought some interesting opportunities.

It was big leap of faith because what you’re taught in school is that you want some competitive advantage. Patents. We had patents at Biotech Solutions. The company we merged with had patents that were very complementary to Biotech’s, and it’s very easy to sell when nobody else can sell what you sell and it’s very easy to explain to investors, “Here are our proprietary advantages.” What we do at U.S. Labs, we do better than anyone else. That is our advantage. It’s execution. We’re a high-service model in a service industry where many of our competitors don’t understand that and are focused on other areas. But in everything we do, there’s nothing really proprietary. What we do is hard to do, but it would be difficult to explain to Michael Porter what our competitive advantage is in a traditional manner.

I did know, though, having met with pathologists for years, that they were under a lot of pressure. They were hospital based but work was leaving the hospital. They were being required to deliver more advanced tests to their customers–the oncologists and the surgeons at the hospital–but the tests required additional funding because the equipment was very expensive, $80,000, and they didn’t have the money. So they would go to the administrator and ask for the money and the administrator was under pressure too and was not about to give them the equipment that they fundamentally needed in order to do their job and service their customer base. I felt that a properly structured company could support doctors, make their lives easier, and not threaten them, which was an issue since they had a lot of people threatening them and a lot of problems in their community. I felt I could take this part of the business–advanced testing for cancer–off their hands, let the pathologists continue to make the living they wanted to make off their core businesses, and satisfy the rather demanding customers they had at the hospital for the advanced tests by providing the tests for them.

Another aspect of the opportunity was that hospitals had been forming chains and they were making a lot of noise about outsourcing everything they could. They started with the easy stuff–the laundry, the cafeteria–then they got to more advanced stuff–record-keeping, pharmaceuticals–and the next natural place to go was the pathology lab. Invariably, due to the economics and lack of scale, the hospital lab lost money for the hospital. The way it worked is that generally the pathologist had a contract with the hospital to provide services in which the pathologist got paid the professional component and made a good living, but the hospital had to produce the slides and lost money at it. So we knew that certain hospital chains were interested in outsourcing and I ran the numbers on it. It was very compelling, with tremendous economies of scale to centralize on a regional basis. And medicine, while nationally a huge industry, is very regionally delivered. I recognized that we could operate regionally and outsource services to a central facility and have tremendous cost savings by doing that.

This problem was not unnoticed. Other firms had tried physician practice management models to address the issue. They were being met with a mixed reception at best. Most pathologists were very much against the idea because they felt that it would take away their freedom. They generally were partners who had a contract with the hospital and they had a lot of freedom. They were making a lot of money. Other players were trying to do labs, but they included working with the blood component of it, which was not a very good business, since it's a very large volume, low-margin business, and is highly capital intensive. We wanted to stay with tissue-based work alone. It's harder to do. It has better margins. It requires a lot more work, so there are fewer people trying to compete in that arena. There were only a handful of competitors. There were other people trying to operate the labs by keeping the labs intact in the hospital. We could not understand how they could do that economically, and none of them have survived. We felt it needed to be centralized among several hospitals and that the best way to do that would be to go to a hospital group that had, say, six hospitals in a region and say, "We will centralize your labs for advanced cancer testing." There have been several attempts by hospital chains to centralize their labs themselves but due to the politics among doctors these have met with extremely limited success.

The use of monoclonal antibodies had become a standard of practice by this point, in 1996 and1997. There had been some seminal lawsuits against doctors who had not used these technologies and patients had died. So any resistance to these tests, although higher priced, had gone away. They were medically necessary, but they were difficult to perform, and the equipment only became more expensive because there were fewer competitors. There was a limited number of vendors and they were pricing their equipment accordingly. So there was a huge capital requirement to form a centralized lab that dealt with tissue. There were expensive pieces of equipment, some of which cost over a quarter million dollars, and the typical doctor group or hospital group was not prepared to invest that just to get the lab up and running.

I felt I had access to capital. I felt I could fill this void and create a very profitable enterprise. One downside is that pricing in the industry is regulated. We can't do anything without the government allocating a code to it and a price. So we're in a very regulated market, and the government sets the price and if we can do it cheaper than that we make money. And if we don't, we lose money. So as a central lab, if we can get our costs down, that's how we make money, and we can do it much cheaper than a hospital-based facility. This is mostly due to better use of labor. That's something I learned at Harvard. If you're in a service business, you've got to learn about staffing for peak, and you've got to understand that people sitting idle in a service business is the same as a manufacturing concern making product for inventory and just throwing it away when they're done. So we need to keep people busy and that's been a big factor in our success.

I originally thought the key driver would be that there was a vacuum in the marketplace, that we had capital and management skills, and we had relationships with a large number of pathologists and with a large number of hospital chains. So we saw a real need in the marketplace and we thought that by centralizing, and by working with the pathologists that we could be successful in fulfilling this need. So, as an entrepreneur, I saw a need in the marketplace and a way to fill it and I tried to move in to do it.

Launching the Company

I started the company. My bank was doing well but I decided to wind it down so that I could try this. I saw the opportunity as a big one. I took some of the money I had made from Biotech, in particular, and went to some of my investors. Some people had made a lot of money off of that deal, had been with me on other transactions, and I told them that I was at a point in my life where I thought it might be appropriate to run something

I put up $1 million and raised $1 million from other people in equity, and owned 51 percent of the company. It was 50/50 but I own the hyphen. That was very important. I started the company and we went about our business for nearly a year trying to prove the concept. We landed some really prestigious accounts, including Scripps down in San Diego and City of Hope National Medical Center. We were running pretty well. So I wanted to scale up, and I was also running out of money, to be blunt. We were losing nearly $100,000 a month. That had a lot to do with cash flow. When you get paid four months after you perform the service, managing cash is very, very important.

Growing the Company

I started looking for money towards late summer of 1997. I did the usual laps around Sand Hill Road. But as I walked into some of the offices at the end of October, one publicly traded physician practice management company went public. There was a tremendous buzz in the venture community about physician practice management in general, and a belief that pathology had unique drivers that made it particularly suitable for a physician practice management opportunity. And they suggested that to me. And it was very compelling. Here I'm running this company, kind of feeling off the fast track, stuck in this empty shell of a building all by myself and trying to hire people in the economy and there's 1 percent unemployment. You can't hire these really talented people. So his idea seemed to suit me. I had done a lot of deals. I understood this market very, very well, but I didn't quite understand the model. He kept explaining it to me and giving me copies of all of his presentations, but I didn't quite understand it. It was almost like a perpetual motion machine. Every time you look at one of those and you track it, there's always this black box that creates energy. It was like that with this. There was a part I didn't understand, but very prestigious firms were excited so I was interested.

There's a whole game to raising money. Do you tell firms that you're talking to other ones? As it played out, I told another player that this guy was interested. She immediately picked up the phone and said, "If you're in, I'm in." I'm standing there kind of star struck. This is how it's supposed to happen. The offering documents for that public company were incredibly complete. One of the thickest S-1s you ever saw. They had done six or seven acquisitions. They had to fully disclose every one of them. It was a lot of work, but it was very easy to go through and study that and completely understand what they were selling to Wall Street, what the concept was. So I was able to take that information, repackage it, put it into a PowerPoint presentation, and say, "I can do this too."

The real zinger was not only was this a change in strategy; they also wanted me to close the lab down. They didn't see a need for it. So I kept pitching them on this consolidation idea trying to massage it into the PPM idea, and the final line was the lab's making money so why would you kill something that's making money? And they finally agreed to keep the lab as I long as I focused on the physician practice management model. I believed in these people. I was amazed by their backgrounds and where they were and the vast quantities of money they had available. I felt I was gaining partners who really knew what they were doing, that they were just going to package me and we're off to the races. I guess even though in my gut I didn't agree with the strategy, and I didn't really understand it, I acquiesced. I deferred to their judgment and that was one of the few times I've done that in this business. And it led us down a path that I'm not sure I would take again. On the other hand, given the circumstances, would I do it again? I did what I thought was the right thing at the time. But I probably should have pressed more to understand how does this work. Why is this going to work? But I think it's a lesson. It's like the dot-com craze. Everyone gets swept up in something. Wall Street loves it. The math was easy. You're going to buy low. You're going to sell high. You don't need to go to Harvard to learn that's how you make money.

Physician Practice Management

The basic concept behind a physician practice management model is that physicians spend too much of their time managing their practice and not enough time doing what they're trained to do, which is reading slides. So if you take a physician who spends three or four hours a day reading slides and the rest of the time managing the business, and you take the management responsibilities away, their productivity and profitability skyrocket. The way it's executed, though, is very different, particularly in California where we have a large number of rules limiting corporations from practicing medicine. So we spent a very large amount of money, at least half a million dollars, drafting documents that would allow us to comply with the regulations and yet do what we wanted to do, which is effectively buy the practice from the doctors. The only problem was that after you pay for this, you're not allowed to own it. It has to be owned by a doctor.

The larger issue for us in California is that there were a large number of lawyers who made a living going around at conventions and conferences telling doctors that PPMs are illegal, that they could and should get out of them. So from a doctor's perspective, he had just received millions of dollars for selling his practice and now the lawyers were telling him he could keep the money and have the practice back. For them it was a no-brainer. It's not appropriate to question their ethics. Their feeling was you were dumb enough to give me the money and this lawyer's telling me that the deal's illegal. I'm still keeping the money. It was very difficult to deal with people under those circumstances.

The venture guys told me before we closed that they were excited about the opportunity. They thought I was a great guy, but I didn't know how to run a PPM. I've never run one. So they wanted to get somebody who had. That led to a lot of other feelings as an entrepreneur. And my feeling was here I've built this country western beer hall and I'm singing in it and they're telling me we're going to hire Garth Brooks to sing at it. I still get to keep the cash register receipts, so why wouldn't I allow that? They said you have to find this person. We'll give you a bridge loan, $750,000, but you have to find this person before we fund the rest of the $15 million. That put me on a course to find someone right away. I'm not saying the only qualification was whether you could fog a mirror, but there was a huge motivation to find someone very quickly who satisfied the VCs requirements. And that's what I set out to do, and I did. We found somebody. We hired a big head-hunting firm and we hired somebody who had the appropriate pedigree to do this. That person became CEO. I was still chairman, which helps a lot; it puts you in a position where they really can't fire you. You have to have a meeting in a year to elect a new one. So that gave me a little bit of comfort, and it was probably part of why I was able to stick around. And we closed our first deal on a PPM in August of 1998.

The Market for PPMs Turns

You've got to understand the environment we were in. During that summer of 1998, right after we began the funding, the PPM market collapsed. There were some very large, billion dollar companies focused on managing physicians, not in the pathology area, but for general practice and things of that nature. They'd been very well liked by Wall Street and now it was like the emperor had no clothes. All of a sudden the bubble burst. So here we are marching headlong into the physician practice management industry; it would be like buying a soda company and then learning Coca-Cola is getting out of the business. Well, we learned the hard the way. We bought this practice in August, and almost from the word "go" it was bad. The doctor didn't want to sell. He sold because he wanted the money. He had other issues pressing on him and it was just very acrimonious.

By January of the following year, the culture of our company had changed dramatically. As one consultant who came in said, "It feels like the air's been sucked out of this building." It was time to replace the CEO. Initially, I had negotiated with this new CEO and had agreed to get an office off site. I respected his position that he had to get rid of the founder as fast as he could because I was the spare to replace him, and that's in fact what happened. I got the three VCs together and told them what my concerns were. They were not unaware of the issues. The company was not hitting plan. Things were not going as we'd had hoped. We treated this gentleman fairly. He had a good severance package. But they were very clear. You are not, Mike, going to run the company. That is not the plan. I said, "Well, I'll do it in the interim."

That was a very hard moment for the company. Everyone at the end of the day is worried about their own job and their own position and is the company stable and is it safe. I wasn't thrilled about what had happened or even about my role in it. But I had to put on a very positive face and show leadership. I know I scared the VCs, as well. Changing out the CEO is a very troubled time for a company. But we managed to get the company stabilized and by the summer we were working on what we were going to do with this thing. We were trying to make the physician practice management approach work, but the industry had fallen apart and Wall Street had caught on. It used to be that you could buy a practice at three times EBIT and sell to Wall Street for seven. Now that had reversed. But the doctors wanted seven times because they were reading yesterday's newspapers and now Wall Street was paying less than three.

Back to the Lab

There were still a lot of unmet needs in the industry–the reimbursement pressures on the hospitals, the need for new technologies, etc. So we developed a new "affiliate" model to address those issues while not owning the doctors. They were independent of us. They got to keep what they had. Their current practice was their practice, but we would provide marketing and sales support to enhance their practice. Pathologists at this time were working two hours a day. They had no work because, for example, all the surgeons had gotten together and had formed their own surgery center across the street, but the administrator wouldn't let the pathologists service the new surgery center because the administrator felt that the surgeons had taken business out of the hospital. So the hospital-based pathologist is just taking gas.

Our pitch was that we would help them hold onto their hospital-based work. We would come in and support them with our laboratory and our marketing. We would get work for them. We'd go to the surgery center. We'd go to the dermatologist. We'd go to the gastroenterologist. It was a model that was very intriguing to all the doctors. The only thing it didn't have was a large check going into their pocket. Within a short period of time after that we decided we were so fed up with the PPM practice we had purchased that we actually just said, "Go away. Just leave. Keep the money." We had purchased them with cash, stock, and a note. And we said, "You give us back the stock, and just go away." That was how desperate we were to get out of that business. And believe me, it was not a pleasant board meeting proposing that to the venture capitalists.

What I wanted to do was get back to what I saw as our core business–the reference lab. By May of 2000 we divested from the PPM, so the next month's business was just our core lab business and annualized it was \$3.6 million. We had done nothing for that business for over a year and a half. And the PPM and affiliate models were incredible distractions to us. So we looked back at what we had. We had a really nice little business here. Nice profit margins, servicing a very happy customer base, and doing a lot of good for the world. It's important to understand that diagnosing cancer correctly is instrumental to treating it correctly. And I would argue that one of the reasons the war on cancer had done so poorly from when Nixon declared it in the early '70s until now is that diagnosis was very, very rudimentary, and very poorly done. We provide a world-class diagnosis to hospitals–primarily smaller community hospitals. So patients are at least being told correctly what is wrong with them, and then their oncologist can go to the protocols and give them the proper treatment.

This was in June, and by August I had put together a new plan. I had the whole team on board and that was a big part of it. I was hiring some new people in the face of great losses. We were losing tremendous amounts of money. We lost half a million dollars in September alone. The affiliate model wasn't working and people were aware of that. We had opened labs in L.A. and San Diego. So we were actively trying to fire some people to scale down, meanwhile trying to hire sales people and people to focus on the core lab business. We had just hired thirty technicians down in San Diego and we were letting them all go. Trying to hire people up in Orange County only fifty miles away was difficult. The bigger challenge was convincing the Board of this. Frankly, two of the VCs signed off at this point. They just said no. They had entered it as a PPM. It hadn't worked. In their minds we should just write this off. There was some intelligent thought behind it, but they were healthcare investors and that was part of what they wanted to invest in and it hadn't worked. I'm not a VC, but I can appreciate that's how they think. And they didn't have a lot of confidence in me or the plan or anything, and they didn't like the new idea. I guess they didn't like it when I pitched it to them years earlier, so why would they like it now?

Medical Advances

There were some other changes by now. Genetics was becoming a big buzz word and we were extremely well positioned for what I saw as the coming genetics wave. I tried pitching them on this. They didn't really have faith in or care to hear about where esoteric and genetic testing was headed. They felt I was trying to just keep this thing alive. They were embarrassed by the situation, and they wanted out.

The early indicators were that the first applications were going to be tissue based, not blood based. There are a lot of attempts right now to determine minimal disease in blood, and we all hope that will work. But at the end of the day, diagnosing cancer is not the great book everyone thought. It's kind of like the Cliffs Notes version, but what we do understand about genetic pathways has had tremendous applications in cancer. There were a number of important pathways within the cell that were understood in cancer very, very early in the process. And we knew that there were drugs being targeted for those pathways, and that in order for those drugs to be properly administered, you had to do the test to determine candidacy. And we were reading papers and kind of talking to people about what was happening. And there were two areas, one in breast cancer and one in cervical cancer, in which there were very important discoveries being made.

In cervical cancer there was a discovery that human papilloma virus, which is a sexually transmitted disease, is the proximate cause of cervical cancer. That's an important thing. We should be teaching twelve-year old girls this. The way to test for it is to apply genetic testing to pap smears. Prior to this, pap smears had been a terrible business. Low margins, nobody wanted to do them, so in June I decided we were going to go into it heavy. I felt that a percentage of market share would never be as cheap as it is today. Nobody wanted to be in this business. Margins were 40 to 50 percent. But we knew this genetic testing was going to come out. And it did. It came out in March of the following year. And we are very, very strongly positioned in that and doing extremely well because the genetic tests have high margins and not many people can do them.

Similarly with breast cancer, there's a drug that was the first antibody-based systemic drug approved for human use. And it ties up certain receptors that are emitted by a certain gene sequence. We knew that there was a test coming out for that that needed to be performed. The drug, Herceptin, would be useful for about 30 percent of women with breast cancer. Typically when you have these new aggressive drugs, a lot of patients will scream, "My HMO won't let me have it." And the HMO will just acquiesce and give them the $40,000 drug so they don't get sued. Well, Herceptin has a high incidence of death as a side-effect, nearly 6 percent. So that allowed for an intelligent, scientific approach to this drug to say we will give it to the candidates, but we need to test to see who the candidates are. And the test costs about, well, depending on how you do it, between $103 and 350. The most precise genetic-based test is $350.

And that's the one we, of course, advocate. We think if it was my mother or wife, that's how I'd want it done. And that created a whole new market. We were doing a fair number of breast cancer cases. And we knew that this was an add-on test with high margins. We've already paid to go out and market the test. We've got the tissue. We paid for transportation. It's here. We will just add another test. The technology was changing and we were very well positioned.

We tried pitching this to the VCs. I was telling them let's go, let's go, I only needed a couple million more dollars, and they were telling me, you don't understand, we are done. We are done. Now, we had burned through most of the money by this point, but they had been paying throughout this disastrous year of 2000 to fund these losses. And they could have easily just cut and left. They could have said, I know we committed to $15 million and we've only paid $8 or $9, but we're not going to pay the rest, let's just close down. I feel they acted with great integrity, continuing to fund into a situation that they did not believe in. That's where we were in December of 2000. Getting to January 2001 was quite a ride. From June of the prior year, when we had that $300,000 a month of revenues, we had grown to nearly $750,000 in December. I think we cleared $800,000 in January. We were, I felt, only a month or two away from generating an operating margin, which is saying a lot. We had an infrastructure in place to scale up to being a very large company. We had a lot of senior managers. Our revenues had nearly tripled in six or seven months. Meanwhile, the two lead VCs had made it clear they were not interested in participating, and had quietly gone about trying to find someone to buy the company. I had been somewhat involved in those conversations because as they got closer, these people wanted to come down and meet with us.

In January 2001, a number of things happened. We had an offer for the company, but at a very low price. These people had come in, had seen us, they knew we had no money, that we were growing fast, that it cost cash to grow, and we did not have any cash. We were in serious trouble.

Conflicts with the Bank

Our bank was very upset. When I started the company I had borrowed some money from the bank to get started. A half-million dollar SBA line was part of it and then they said we'll give you $750,000 so you can pay off your personal SBA loan, and you'll have another quarter-million dollars of working capital. And that's when the VCs were first coming in with $15 million. Well, the bank suddenly felt they had this huge line of credit out to me, $750,000, which was never secured by anything, and they were very uncomfortable with it. Also, when we had gotten out of the PPM business, and had just told the doctors to go away, there was a receivable of $900,000. Now that receivable was not collectible. We had collected maybe half of it, and like any business when the receivables get to be nine, ten months old, people don't like lending against it. So the collateral that the bank felt they had, had been worked down. They felt very uncomfortable that there was no collateral here. Then you couple that with what were they really lending into? This bank lent to venture backed firms with the faith and belief that the venture firms would bail them out if things went wrong.

Well, the world had changed over this year. The dot-coms had blown up. Things had changed a lot and the bank was having problems with a lot of companies, and they were losing money. They were terrified; they kept calling our backers and they were not getting the warm fuzzy they wanted. What they wanted to hear was, “Yes, we’re going to stand behind this and we’re going to fund it and you will not lose money in this, if we have to pay you off, whatever it takes.” That’s not what they were hearing. I wasn’t party to the calls but it was enough that the bank was extremely upset. We were, however, amortizing the loan. We were paying $67,000 a month of interest and principal on this thing. My feeling was that we were making the payments, so what’s your problem? But I knew what their problem was.

In the beginning of February 2001, I told the bank, with great sincerity, I said, you’re backing the wrong horse. You’re backing VCs and you’re getting your clock cleaned left and right. No one has ever lost money in a deal I’ve done, and you are not going to lose money on this. I will take care of you, but you need to stand still, and you need to give me time to work this out. Their answer was, that’s not good enough. I said, really, I’ve projected we need $1.2 million to get through to breakeven. I’ve raised that $1.2 million and I personally am putting in half of it. Nope, that’s not good enough. The money has to come from the current venture group, that was their response. I found that offensive, and I’ve got to tell you that reaction is what soured me on the bank. So that was the situation in the first week of February 2001. A few days later they called the loan. Our poor CFO just about had a heart attack, and he came into my office all upset.

I’ve been around the block, and one of the places I was for a short time was in an investment banking group of a commercial bank. My boss there had been involved in a lawsuit. He had a client who had sued the bank under some lender liability theory, and the jury went for it. The client sued the bank and the jury awarded him $10 million. So I had taken it upon myself when that happened to learn about lender liability. So I had a very different view of who had power in this situation and who didn’t. And when the bank called and said all this stuff, I just told them, no, you are not going to do that, and here is what’s going to happen to you if you try. I took a very strong position with them, and said, in fact, at the end of the day it might really take care of my family for the rest of my life if you do this. So think about it really long and hard because I have enough money to sue you and to sustain a battle against you, and to prevail. And they had never been spoken to like that before. They were stunned at my response. I also reminded them at this point that I had personally promised to take care of them. And they backed down.

Staying Alive

Now, I felt that the market for esoteric testing would be fueled by the genetics revolution, and that the first application of the human genome project would be in the diagnostic field, particularly in our field. But February 2001 was a miserable time. I knew we were on the brink of success but the VCs wouldn't even listen to me. We had a great new VC but he wasn't even on the board. And as he told me then, he said, "We are very good minority investors; we stay out of the way and let the lead be the lead. But when we become leads, we're very good lead investors." So my goal at that time was to get him to become a lead investor. Now to keep us alive, I needed $1.2 million. I had done it for another reason as well, and that is that the company was in play, and I did not think it was appropriate to sell it. I knew this competitor was trying to steal it, and they knew we were down, and they were trying to take it away from us. I wandered through Wall Street, and the I-bankers were telling us that this thing is worth a lot of a money. You've just got to stick it out. And of course, they'd always ask, how much money do you have. I'd reach into my pocket and show them I had cab fare home, that's it. And they told me, you just have to get a couple million dollars. It was a bad time.

Now we were having weekly, Friday morning phone calls, which basically consisted of the VCs telling me to sell the company. Fortunately, the new VC always had a high opinion of me. And his position was that this company has increased sales nearly threefold in the last six months with no money, and we got Mike here who thinks there's something here. He's ready to put everything he owns into the company. To him, that was something he needed to look at, and he actually assigned somebody to start taking a look at us. But he said make it a quick trip because Mike might be out of business by the time you get there. They were also gracious enough to invite me to a CEO summit that they had at the beginning of February. Of the approximately fifty people invited, 10 percent of them had gone bankrupt from the time the invitations went out until we all met. And I seemed to be always stuck with them at the table. So I knew he was trying to give me a message here, that you're going to go under and here's how we treat people when they go under.

So the company's in play. Now this is going to get a little technical, but it's a valuable lesson. We had formed the company with common stock that I owned most of, and by now had been diluted. Series A is what the VCs invested in, and Series B was the stock we had planned to give to doctors, but there was no Series B issued at this time. None. So when I put up my $1.2 million, I took Series B stock. I took warrants for Series B stock, which I immediately exercised. I also got a security interest in the company behind the bank. So now all of a sudden I went from being the dirt bag founder who's about to get washed out to owning an entire tranche of important stock. We're a Delaware corporation, but in California every tranche of stock, every class, has to vote for a merger. Now I would have of course immediately filed and said, we're an ailing corporation in California, but California law applies. So I felt that gave me a very strong position in dealing with these VCs who wanted to sell that I controlled an entire tranche of stock. I had 600,000 shares or so of this stock, half a million shares, and I had a security interest behind the bank. So that also gave me a certain amount of power.

Now I am fully pregnant with this deal. I've got everything in it. I'm out at the CEO summit, and it seems like everybody I talked to says you've got to just stay alive. One of the things we used to say at Drexel is that for our clients the cost of capital is not important, access to capital is what's important. And believe me, in January, February of 2001 for U.S. Labs access to capital was everything. We needed it to stay alive. I got diluted but by this point I was psychologically ready for the down round. I wasn't ready for how down it was. It was devastating to my ego, and to everything. I did however make sure that the investors I invited into it were provided for in this. I was the one who took it mostly, in the shorts, on this one. But I felt given what happened, that was appropriate. But the new VC backs management teams and he backs entrepreneurs. He gave me stock options based on certain performance hurdles. He also was very fair with the rest of the management team, particularly the senior people who knew what was going on. It's kept our team very engaged and that's why we've hit our numbers this year.

Lessons Learned

There was some solace in the fact that the market was really bad and a number of other companies were taking down rounds. The lesson is that you need to live to fight another day, and you've got to do whatever it takes to keep the company going. And 5 percent of a big pie is better than a big piece of a small pie; dilution is something that entrepreneurs focus on too much. I have focused on it too much, and the lesson I learned at the CEO summit was to take money and go on and fight and create something of value. It may affect how big my jet is at the end of the day, but I will still be able to make a lot of money here. And I wanted to continue to do this. I absolutely believe that what we are doing is important.

I also have a great team of people here. Could you imagine going to my senior management team, some of whom bled for me for four years here, and saying, "You know what? I wanted fifty cents a share and they offered me nineteen cents so I'm going to close down." Their options are down in the two to six cent range. I took care of them, and our new lead VC took care of them. I was not about to fire 100 people because my ego was hurt that I used to own half of the company and now I own 5 percent of the company. Was it fun? No, it was a bitter pill to swallow. It's kind of an acknowledgment of all the mistakes you've made. But that's why we sit in this seat. And one thing I learned in the Navy is that when the bullets start to fly everyone looks to the man wearing the gold braid to make decisions. This was my decision to make and I couldn't allow my ego to get in the way of doing the right thing by everybody involved. And at the end of the day it's going to work out right for me, as well. Don't give up the ship

One Year Later: December 2001

A year later, everything I projected has come true exactly. We got to breakeven. We actually made money in March on an EBITDA basis, first time ever. As soon as the March numbers came in, our new lead VC gave us a term sheet. We ended up getting oversubscribed and did $4.5 million, and brought in some great other players as well. We hit every number we projected and in October 2001 we took in an additional $15 million. We're talking about going public next year, and the numbers are staggering. It's very exciting what they think we're worth.

We have been uniquely positioned to take advantage of what was going on with the genomics revolution. And today, in addition to the Herceptin tests and the pap smears with the HPV tests, we do a lot of flow cytometry, which is a different method of applying antibodies to cells. What was being learned more and more was that there were tests that had been around for years but really had no clinical utility in the area we call cytogenetics. You do a flow test and all you can say is, the patient has this disease, and they're going to die in three months. Then there was a discovery that if there was a certain gene rearrangement between chromosomes nine and twenty-two, for example, in chronic myeloid leukemia, that there was a drug now called Gleevac that could be administered to that patient. Now everyone wanted not just the flow test, which cost $1200, but also a cytogenetics test, which cost an additional $1500, and the great news was it was saving lives. Now instead of having to tell this poor patient that they're going to die in three months from this disease, doctors are now able to determine if a certain drug will work for the patient. And it sounds terrible to say, but the patients are living and will need to be tested constantly for residual disease while they're taking the drugs.

We are leaders in the application of genomics to cancer. Cytogenetics is now a standard of care for most leukemia and other cancers of the blood. And we are leaders in that area. We are branching our genetics out into other markets because our core competency in genetics is applicable in other markets outside of cancer. And some of these markets are enormous. For example, the American College of Obstetrics and Gynecology recently decided that if you are a Caucasian and you intend to have children you need to be tested for cystic fibrosis. This comes into effect as medically necessary. All insurance companies have to pay for it. That created a $300 million market overnight. Our customers are clamoring for this test. They don't know where to get it. They have to start administering it in January. So we are aggressively trying to position ourselves for that. Two weeks ago, a gene was isolated for spinal bifida. That will create another test. We estimate a $100 million market. Just about every month now, the FDA approves a new cancer drug that requires genetic testing. Each of those is a $30 million market. And our positioning as a brand for U.S. Labs to pathologists and oncologists and attending physicians is whatever test somebody asks for, whatever new genetic-based test there is, we will do it for you. We are here to take care of you.

Emerging Challenges

Going to scale is our big challenge right now. That's why we took in this $15 million. We have more than doubled the number of employees, from 100 employees to 250. We moved from our 11,000 square foot offices to 53,000 now. We can't fit. We need to take another 50,000 across the street. We have our own U.S. Labs university to train people because we are growing so fast and the area is so new that there just isn't enough talent out there. We are shopping sites now on the East Coast. We're going to be opening throughout the East Coast and in the Midwest for logistics hubs to enhance our service to our customers. We have to hire technicians and pathologists. And we are just way ahead of our plan. It's very exciting but it's tough.

We're very profitable, which is nice. As our new lead VC likes to say, good things happen to profitable companies. And a lot of good things have happened to us. The team is energized. They're vibrant. One consultant we hired believes we could easily go to $1 billion over the next five or six years given the market and our position. The market is far bigger than we thought it was. These tests are creating overnight, every month, huge increases in the market. And a lot of our competitors don't have the vision for what's going on here. A lot of them go by disease state. We're breast cancer or we're urology or we're prostate cancer. It's very easy to quickly saturate your market if you define yourself that small. I learned from them that I do not want to be defined so narrowly. We have positioned ourselves instead as experts across a wide spectrum of disease states, and now we're focused on being experts in genetics, which is on the minds of a lot of doctors right now.

When I was at Harvard and we studied competitive strategy under Porter in business, I always felt that there was another aspect to success in business and that it is just pure execution. At U.S. Labs, we are executing exquisitely and crisply. We do it right every single time. And that is a competitive advantage because our competitors always trip, and when they do people are hurt in this business, and somebody's mad and they're willing to give us a try. We also work hard on branding ourselves as a reference lab, as a genetics lab, and that's paying dividends for us. We have nothing truly proprietary. But we do work for some of the major cancer institutions in America. The tests are ostensibly off-the-shelf kits, and these institutions can't get them to work but we can, and that's because we focus on executing. We pick it up and we get it in here. We make sure the sample is viable. We process the sample correctly, which is very difficult to do. We analyze it using our doctors. We have QC controls to make sure we get the right diagnosis out. We do follow-up testing. We have algorithms that if this patient has this indication then the following tests need to be done.

That, by the way, is another change from our competitors. For them when you order a test, that's what you get. For us, we are looking for an answer for the patient. That also, by the way, enhances our revenues because we recommend additional tests. Legally, that doctor has to order those tests, but they understand what we call the care map. You see something, you do this, you do this, you do this. We do it in the diagnostic area. Nobody else does it that way. We make sure we get an answer to the doctor. We also do the tests faster than anyone else. When our competitors started, their competition was academia, which took three or four weeks. They were structured for a turnaround of five to seven days. We are structured for twenty-four-hour turnaround. In everything we do from pickup to delivery to customer service, that has been a sustainable advantage for us. And since our industry has fixed prices, these are the areas we compete in–speed, quality of service, accuracy. We provide better service and high-quality results at a faster pace. That has turned out to be a sustainable competitive advantage for us.

One of the complications of our business is that we have a patient at one end and then we have an attending physician and then we have a pathologist before they get to us. And in some cases there's actually another lab between the pathologist and us. There are some small regional labs that send all their esoteric work to us. So defining our customer is very, very critical to us. We have a number of different customers. We have always viewed the pathologist as a customer and someone we need to support. With the PPM model we thought we could buy the pathologist. The political power of the pathologists is far greater than you ever want to admit. They are at the hospital all the time. They work the system. They are part of the existing establishment, and they are very powerful people. And part of the reason the PPM model did not work is that they were not going anywhere, and they were not very supportive of the idea across the board. But as a customer, they're great. And we understand that it's our job to bend over backwards and make sure they're happy. But when they were our partners we expected them to provide insight, advice, and guidance. So this is all working out well now.

Summary Reflections

As an engineer and as a guy who's been stuck underwater trying to fix a pump that if I don't fix it, we're all going to die, I've learned to just not say no and to continue to try to different ways at the problem. And if this way doesn't work, that doesn't mean I've failed. I have to go and try this way, and try this way, and try all kinds of different ways. That's been critical to the company's success. I do not give up just because what I just tried doesn't work. I just keep doing it and doing it. I drive some people crazy sometimes. But for me it's not over until I get it.

The hard part when you have a team behind you is that they've got to keep following you even though the strategy keeps changing. So you've got to have reasons for what you're doing so people will get energized and follow the leadership, and if you're all over the map, no one's going to follow that. You've got to have direction. People understand that it's like running a play off a scrimmage and that you're not going to keep running where you were; you're going to look for a hole. You've got to zig and zag. Life's like that. That's the way it is in business. You're going to try things and they're not going to work. I've told the board, I've made some big mistakes. One of them cost us a couple hundred thousand dollars. Are we going to cry about it? No. We took the hit and we closed up that division and we moved on. And we’re OK. We learned a lesson and we moved on.

My advice to entrepreneurs is to do your research. You have to know the details. You have to know the market. It’s like playing poker; you have to know the odds, but at the end of the day you have to look in the faces of everyone else at the table and that’s how you win the game. And you’ve got to go with your gut instincts. Every time in my career and at U.S. Labs that I have acquiesced to somebody else’s judgment, it has gone poorly for me. When my gut told me this wasn’t the right idea, and I have ignored it, I have lost. My advice would be, whether you’re right or wrong you need to do what you think is right and just make it work. And it is not easy when all of these very smart and very persuasive people are telling you you’re an idiot to stick by your guns, but there is no substitute for that. That’s the biggest lesson I have learned.