McKinsey Under Rajat Gupta

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The article discusses the issues related to McKinsey's close connection with the bankrupt Enron and also the failure of its other prominent clients like Kmart, Swiss Air and Global Crossing. The article also addresses topics like change in corporate culture, McKinsey's aggressive growth strategy and its outlook for the future.

For the past few months, McKinsey & Co has been in the news for all the wrong reasons. Rajat Gupta, the Managing Partner at McKinsey, is facing a few important issues like client failures, change in corporate culture, etc., and that need immediate attention. The problems for the company started in December 2001, when Enron filed bankruptcy. McKinsey has had a very close relation with Enron for the past 18 years. It was McKinsey that advised Enron on its innovative principles like "asset light" strategy, "loose tight" culture, securitization of debt, etc. Also, former McKinsey partner Jeffery K Skilling, has served as the CEO of Enron (such corporate move is not uncommon for McKinsey. In 1978, McKinsey partner Louis Gerstner left for American Express and later became CEO of RJR Nabisco and IBM). Because of this close association with Enron, McKinsey has received its share of bad publicity. Though it is not implicated like Arthur Andersen, there is a significant issue to be addressed—did it cross a legal line while advising Enron?

Recently, McKinsey took measures to answer this question. Rajat Gupta sent his chief legal counsel to visit Enron's offices in Houston, Texas to look for any evidence that would possibly link McKinsey to the fraud at Enron. Much to the delight of the entire company, no files were found that showed McKinsey ever helping Enron with its off-balancesheet accounting policies. Rajat Gupta commented: "In all the work we did with Enron, we did not do anything that is related to financial structuring or disclosure of any of the issues that got them into trouble. We stand by all the work we did. Beyond that, we can only empathize with the trouble they are going through. It's a sad thing to see." Though there were no direct link for fraud, there is a widespread belief that McKinsey, like the other consultant companies, might have kept things under wrap just to maintain the

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The Enron fiasco is just the tip of an iceberg. Along with Enron, notable clients like Swiss Air and K-mart have also recently filed bankruptcy. Apart from these big names, there is a host of smaller players (that soared during the tech boom in the late 1990s) that have gone defunct and now unable to pay their consulting fees. *BusinessWeek* reporters Joann Muller and Wendy Zellner write: "All of which raises uncomfortable questions about the world's most prestigious and enigmatic consulting firm. Did McKinsey's partners get caught up in the euphoria of the late 1990s and suffer lapses of judgment? And if so, what does that say about the quality of its expensive advice? Did it stray from its core values? What accountability does it or any consulting firm have for the ideas and concepts it launches into a company?"

Let us now briefly look at some of the major issues it is facing now.

Enron Connection

The successful transformation of Enron from a pipeline company to energy giant can be directly attributed to McKinsey. McKinsey partners regularly wrote—in books and articles extolling the strategies employed by Enron to make highlight it a corporate success story. McKinsey began advising Enron in the late 1980s under the direct supervision of Jefferey Skilling, then McKinsey's partner in charge of the worldwide energy practice. The relation further improved when Skilling left Enron to become the CEO of Enron. Under Skilling, Enron created a portfolio of fixed-price purchase and supply contracts that were used as hedge instruments to eliminate supply risks and also to reduce the impact of price fluctuations in the spot market.

In spite of such close connections with Enron, McKinsey's work has mostly been tactical and technical in nature. The consultant company was mostly involved in market research and business development studies for entering into new markets, developing new products and services, acquiring new pipelines, etc. McKinsey, however, did help Enron to formulate a broadband strategy to build a high-speed fiber-optic telecommunications network. Like most other industry players, McKinsey failed to foresee a slowdown in the broad technology sector and particularly in the telecommunications industry.

Such was the association between the two companies that many McKinsey partners eventually left for Enron. A former Enron executive commented: "They were all over the place. They were sitting with us every step of the way. They thought, 'this thing (broadband) could be big, and we want credit for it.'" In their article, J Muller and W Zellner report: "At any given time, McKinsey had as many as 20 consultants at the energy company, several stationed in Enron's offices." They later add: "Over the years, McKinsey partners Hulme and Suzanne Nimocks had numerous one-on-one discussions with Skilling. Richard N Foster, a senior partner, even became an adviser to Enron's board." Coincidentally, Richard Foster later authored a book called "Creative Destruction," that highlighted the problems at Enron.

Culture Change

When Rajat Gupta became the Managing Partner in 1994, his challenge was to maintain the company's growth while ensuring that size did not affect the McKinsey philosophy of a close-knit partnership. While his colleagues argued for a smaller company size, Rajat aggressively expanded abroad, opening up a number of branches throughout Asia and Eastern Europe. Within a year, he had expanded McKinsey's reach to 84 worldwide locations from 58, increased the staff size from 2900 to 7700 and improved the revenues to $3.4 bn from $1.2 bn. The company also saw an increase in partners from 427 to 891. A senior partner in Washington DC then commented, "It's a less personal place than it used to be. In the old days, you knew everybody. That's not possible any more."

Most insiders are of the opinion that the problems the company is facing today are because it drifted from some of its deep-seated values (laid down by the firm's early leader, Marvin Bower). The *BusinessWeek* article mentions: "Through the dotcom boom, for example, McKinsey allowed its focus on building agenda-shaping relationships with top management at leading companies to slip, as the firm took on some distinctly down market clients and projects. Also, the company started advising up-starts and divisional managers at less prestigious companies."

Another perceivable difference was that revenues were given more importance than developing knowledge. One former McKinsey consultant commented: "In an (earlier) era, the whole place had this tremendous focus on ideas. I think knowledge has taken a back-seat to revenue generation. The more revenues you create, the more your compensation and standing in the firm increases." Of course, Rajat and his senior management team, strongly dispute such statements.

During the dotcom boom, McKinsey expanded quickly by taking up a series of consulting assignments from big and small companies alike. When the technology bubble eventually burst in the beginning of 2000 and when many start-ups went bankrupt, the company was left with far too many consultants than it could handle. As a result, its utilization rate (billable time) of the consultants dropped to 52 percent (the lowest level in more than 32 years) from a high of 64 percent. Adding to such woes was the company's revised stance in the mode of payment and revenue generation. The company deliberated over such options as starting a venture-capital fund, going public, starting dotcom ventures as offshoots of the firm's consulting business, accepting equity instead of cash for an assignment, etc.

For the past three years, McKinsey has accepted payment in stock from approximately 150 start-up companies. The equity that is collected is deposited into a trust and liquidated as soon as possible into a profit pool for its partners. Also, new payment arrangements mandated assignment-ending bonus if a client was satisfied with the results. Inspite of such additional bonuses, many consultants left McKinsey for dotcom start-ups like Pets Quarters, Cyber Dialogue, Virtual Communities, Cars-Direct.com, etc.

Notable Client Failures

McKinsey began consulting for K-mart in 1994. At K-mart, McKinsey advised the discount retailer to sell more groceries in an attempt to attract more shoppers. It also advised the retailer on its Internet portal, BlueLight.com, which was to be later spun-off in an IPO offering. Due to unfavorable market conditions, this plan was shelved. McKinsey ended its relation in 2000 after disagreeing with K-mart CEO Charles Conaway, who wanted to pursue a price war against Wal-Mart. Though McKinsey had advised from 1994, there were no significant improvements at K-mart and the retailer continued losing market share to Wal-Mart.

For Swiss Air Group, McKinsey advised it to buy stakes in small and troubled European airlines. At a cost of $2bn, Swiss Air expanded into aviation services, providing everything from maintenance to food for other airlines. This strategy, however, backfired, causing huge losses and a bankruptcy filing in October 2001. McKinsey, however, was quick to respond that it was not liable because they were only involved in strategy formulation and not in the actual implementation.

Looking Ahead

Inspite of all these problems, the company's reputation precedes any other firm. As of July 2002, McKinsey offered its services to about 147 of the world's 200 largest corporations, which included 80 of the top 120 financial service firms, 9 of the 11 largest chemical companies and 15 of the 22 biggest healthcare and pharmaceutical concerns. It has an impressive client base with names like Hewlett Packard, Johnson&Johnson, General Motors, Siemens, Home Depot, etc. At the beginning of 2003, McKinsey is expected to elect a new Managing Partner. Rajat Gupta commented on the current situation and the management change: "In every generation, there are issues that come up that define the firm. We have had our share in the last decade. But I feel very proud of where we have come out." What needs to be seen is if the successor would continue with Rajat's philosophy of growth at the expense of culture and values.■

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