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FORTUNE

VALUE STRATEGIES

Marakon Runners

by Thomas A. Stewart

They launched value-based management—a staggeringly detailed process that takes years. It's made billions for clients. Still, they're the best-kept secret in consulting.

The headquarters of Marakon Associates is very quiet. Not hushed-and-reverential quiet. Not eerie quiet. Not dull quiet. Just … quiet. No glad-handing bluster. No hurried runs down the hall. No wisecracking. Marakon's people are often on the road, but the place is quiet even when almost everyone's in town. They're staring at a spreadsheet on a computer screen, poring over a document lifted from a stack, making notes on a yellow pad, adding a column of figures. You can almost smell the epistemology: The world can be understood, the answer can be found; you just have to dig till every fact's in.

In fact, part of the world—the business part—has yielded up many mysteries to the people of Marakon. The firm, based in Stamford, Conn., is a management consultancy, an absolutely topnotch one, among the half-dozen firms that form the elite in strategy consulting.

Never heard of them? Join the club. Marakon is the best-kept secret in consulting. Its anonymity is not for want of accomplishment. The firm's four founders pioneered—essentially, invented—today's ruling approach to management, creating shareholder value by producing profits in excess of the cost of capital; Marakon helped teach the art to Coca-Cola, its most famous exponent. Over the past five years, Marakon's active clients, all large public companies, have given shareholders total returns 3.1 percentage points higher than the returns of their industry peer groups, and 4.5 percentage points higher than broad market indexes. Taking even the lower figure, the wealth created in those five years is $68 billion above what it would have been if the companies had only matched their peer groups. This sum, greater than the market capitalization of Hewlett-Packard, Citicorp, or General Motors, was generated by only a few companies; at the moment Marakon has 15 clients, among them Dow Chemical, BankAmerica, Nordstrom, and, in Britain, Boots Co. and Lloyds TSB Group.

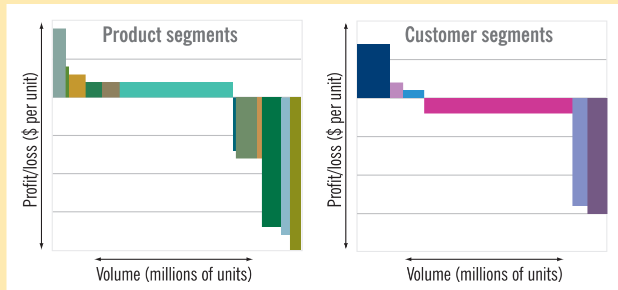
Marakon gets amply rewarded for its work; its revenue per consultant ties McKinsey's—$475,000 last year, according to Kennedy Information, the consulting industry's Dun & Bradstreet. No other multi-industry strategy firm tops $400,000.

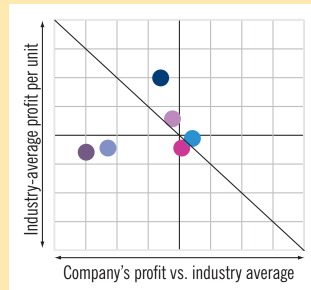
Nevertheless, Marakon is so little known that most MBA candidates at major schools cannot say anything about it. Partly that's because of its size: Twenty years old this August, Marakon employs 200 consultants. Rivals Bain (1,500 consultants), Boston Consulting Group (1,720), and McKinsey (4,627) dwarf it. Partly it's a matter of marketing by seeming not to market. Says Wayne Cooper, publisher of *Kennedy Information*: "There are only 500 people in the world who need to know who they are—the CEOs of the FORTUNE 500 companies." Partly it's genuine reticence; these guys blush when they brag.

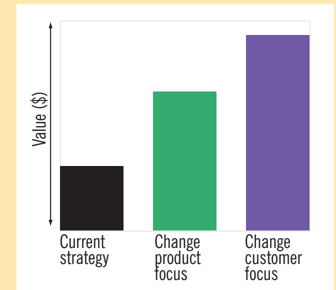
"These guys" are Peter Kontes, the chief executive, and James McTaggart, the chairman. One is dark, the other fair, but there the contrast ends. Born 50 years ago within ten months of each other, they received MBAs from Berkeley and the University of Washington, respectively. In the late 1970s, they were working as vice president (McTaggart) and assistant vice president (Kontes) in corporate finance at Wells Fargo Bank in San Francisco. They agreed that what they were doing there could be much more lucratively applied to consulting and started the firm. After a bit they moved it to Connecticut; they are neigh-

How Strategy Happens

In Marakon Associates' view, strategy is the outgrowth of a process of continuously analyzing economic profit—that is, profit that includes a charge for the cost of capital—and searching for ways to increase it. To do this, organizational boundaries must first be redrawn so that units have enough economic integrity that their P&L can be determined. (The example here is from an actual Marakon client, its name deleted.)







FORTUNE CHARTS

LEARNING WHERE VALUE IS CREATED

Business units do a "deep drill" to measure value creation by product (left), customer (right), or other criteria. "Waterfall" charts graphically—and often shockingly—display where wealth is created and where it is destroyed. The second chart, for example, shows that only three customer segments are profitable; the company is actually losing money in its biggest customer segment (shown in magenta).

EVALUATING STRATEGY

The company looks at the economics of the industry (How good is this business?) and compares its own performance with it (How good are we?). Above, the company's customer segments are evaluated. Similar charts are produced showing performance by product line, geographical region, etc.

MANAGING FOR VALUE

In every planning cycle, managers investigate three or more strategies for each business. The test: Which will most increase the value of the business? Over time, Marakon claims, the process forces executives to seek and invest in attractive markets where the company can outperform its industry.

bors in Greenwich. James McGrath, a third founder, was also at Wells Fargo; he later moved to Australia and joined the A.T. Kearney firm. The fourth, William Alberts, had been McTaggart's finance professor in college; he plays no executive role in the firm but is its chief ideologist.

McTaggart, Kontes, and Co. are not only like; they are like-minded, even single-minded. Isaiah Berlin observed that people resemble either foxes, who know many things, or hedgehogs, who know one big thing. Marakon is hedgehog heaven. Says McTaggart: "We have a very strong point of view. We're the opposite of client-driven." As far as Marakon is concerned, a company must have a governing objective, and only one—to increase shareholder value—and the objective must truly govern. All strategy, all management, all processes, all systems, all decisions, all efforts must serve that goal and none other. Everybody's got a value-based management consulting practice now; Marakon has only a value-based practice, and won't have it any other way. "It's a vice of consulting," Kontes says, "that it provides top management what it wants."

Marakon didn't invent the notion of economic profit—that is, a profit above the cost of capital. That's Capitalism 101: You accept money from investors, do your thing, then return more to the investors than they put in. It's so tried and true that Jesus, who was not big on wealth creation, lauds it in the Parable of the Talents. But the need to produce a positive return on capital gets fogged and attenuated in large, complex companies. Their size insulates managers from markets. They think capital comes from budgets.

What Marakon invented was a comprehensive, four-in-one tool for organizing, analyzing, managing, and strategizing to deliver shareholder value. Says Kontes: "Before us, the consulting industry had no capital-market economics in its practice at all; we showed the way not just in measurement but in management." Thus, though there is overlap between Marakon's value-based management and the more famous economic-value-added consulting of the Stern Stewart firm, the two say they don't compete. Says Al Ehrbar, vice president at Stern Stewart: "Their basic business is strategy consulting, which we have elected not to do."

The essence of Marakon's creed is that strategy is the result of a process; "Strategy Happens" is the title of an essay Kontes wrote. It is not a plan imposed but a pattern inferred from the outcome of hundreds, even thousands, of analyses and decisions made at the smallest possible level of detail. Learning the process takes a big commitment; the typical Marakon engagement—they call it a program—involving just a handful of consultants, lasts three or four years and costs $5 million to $10 million per year in consulting fees. Says Kontes: "The only way we deliver strategy is through these programs. If someone wants a strategy for specialty chemicals in Indonesia, the answer is no." Get with the program, though, and you should be able to double the value of a business every four years.

The stock market values a whole business; the Marakon process depends on knowing the value of its pieces as well. That usually means redrawing internal boundaries. "Most organizational boundaries are political," Kontes says. The new map should be economic, defining units that can be "managed for value largely independently of other units"—for example, because they have few shared costs.

Redistricting serves two important purposes: First, the exercise

builds executive consensus around the idea that increasing shareholder value is the one and only objective; second, the outcome produces business units with enough financial integrity that general managers can become responsible for maximizing their worth. When Nordstrom hired Marakon in August 1997, says co-president William E. Nordstrom, "we were able to measure economic profit in only one place, the bottom line." That meant managers were working inside a black box, invisible to executives and unable to measure or control the effects of their decisions. The new set of business units—geographical and merchandising, chiefly—"allows us to measure where we can manage," Bill Nordstrom says. For example, merchandising managers are responsible for gross margins on the products they pick—which means they, not store managers, own their inventory; but store managers are liable for labor and selling costs, which they can control.

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The measurement job comes next. It begins by understanding costs and profits—learning where and why you are making money or not, and how your competitors compare—at an unprecedented level of detail, down even to the stock-keeping unit. "Their doggedness is incredible," says Richard Olson, CEO of Champion International, who hired Marakon last year in the hope of overcoming a long legacy of crummy performance under his controversial predecessor, Andrew Sigler. One mill in Alabama, for instance, uses four machines to make rolls of uncoated paper, which then go to one of five converting machines, where they are cut into sheets, trimmed, and made into over a hundred products: letter- and legal-sized sheets, hole-punched or not, private-label or not, etc. Not every machine can make every product, but all in all there are 962 different product-machine combinations, and by the time a team from Champion and Marakon was done, they knew the economic profitability of each one. They'd also examined 37,000 customer orders—two years' worth—and done P&Ls for them all. From that information it's possible to see exactly where in a company's portfolio of businesses shareholder value is created and where it's destroyed; and adding them up makes it possible to assign each business a "warranted equity value"—a price it would fetch if sold.

Marakon likes to display the results in a "waterfall" chart, which lines up the pieces of a portfolio from most profitable to most destructive, weighted to show how much of the company's capital is tied up in each. The picture is usually a shock—but so thoroughly grounded in fact that there's no wiggling out from its implications. High-growth lines of business are found to be capital quicksand with no discernible bottom; tiny units turn out to produce twice as much economic profit as big ones. At Boots, everybody knew the company's prescription drug business was where the money was made, and everybody was dead wrong; Boots The Chemists—the neglected retail operation—was the star.

At Dow Chemical, where Marakon is mopping up after more than half a decade of work, the first "deep drill" went into the polyurethane business, which makes flexible foams used in mattresses, automobile dashboards, sneakers, etc. Says Anthony Carbone, executive vice president: "They wiped out myths. We learned basically that we were not competitive in the purchase of key raw materials. It was very arduous. They had just two or three people doing each business, but they are a focused, high-energy group. They go through an enormous amount of data and an awful lot of pizza."

The analysis that produces the waterfall chart sets into motion much remedial work, fixing newly obvious problems, and much more besides. In its first year working with Marakon, polyurethanes identified more than $100 million of "value-creation opportunities"—about $60 million on the cost side. Companywide, Marakon helped Dow cut capital spending 44% in five years. Says Carbone: "We used to throw capital at any problem we needed to solve; you become loath to do that when you have to earn 15 cents on the dollar."

When the profit picture is clear—if not necessarily pretty—the Marakon program moves from the engine room to the bridge. It's time to begin managing for value. In an almost philosophical sense, Marakon believes that to manage is to choose; that to choose one must have choices; and that managers, therefore, must generate alternatives—three or more different strategies for every business, in every planning cycle, at every meaningful level of detail. Then the economics of each alternative must be laid out, using the extraordinarily rich factual material already gathered, plus whatever new research is needed. The question asked of each alternative is not volume, not profit, not market share, but this: Which choice will most increase the long-term value of the business?

That's how Lloyds TSB became not only the biggest but far and away the most profitable mortgage lender in Britain. The bank worked out that it could become the low-cost producer, then that it could choose to exploit that advantage either by offering a lower price or by making a higher profit on each mortgage. In this case, the lower price—and consequent 13% share of new lending, up from a 9.5% share historically—turned out to be more valuable, and continues to. But it is retested against alternatives every year. Says Lloyds TSB's chairman, Brian Pitman: "People generally don't want to go through the intellectual rigor of asking, What exactly do I want to do that's different from the competition?—and do it for three different strategies, every year. But £1,000 invested in Lloyds TSB 15 years ago, with dividends reinvested, is worth £52,000 today."

The process of generating alternatives and choosing on the basis of warranted equity value occurs wherever Marakon works. Dow, for example, struggled for years selling colored plastic, never making money at it. During an option-assessment drill,

someone proposed letting customers do the coloring in their plants. Analyzing the proposed strategy was enormously complex—it involved getting to know customers' costs as intimately as Dow's own—but in the end it was clearly best, and Dow shut down its coloring plants.

The sum of these choices gradually becomes a strategic agenda for the whole company. The evolution can be seen at Boots. Following the epiphany that it was a better retailer than it was a drugmaker, Boots began pulling capital out of pharmaceuticals and investing more in its shops. Says Chairman James Blyth: "People at the top found it extremely difficult, but Marakon are pretty relentless in holding your feet to the fire." Eventually Boots exited prescription-drug manufacturing altogether—selling the business to BASF in 1995. But the company steeply increased research and development in cosmetics, toiletries, and over-the-counter medicines.

That's because of the news from the shops. The relentless tracking of economic profit by item, category, and department was beginning to change every aspect of the business. It goes back to the waterfall chart, where bars representing the high-profit businesses were stacked to the left, and the money losers trailed off to the right, their bars hanging down below the line of economic profitability. Says the company's finance director, David Thompson: "We'd been spending most of our time looking at things below the line, but now we started to look at our core. We began to shift resources to the left, and the right-hand side of the chart got squeezed out."

Imagination may be infinite, but shelf space is not: More space for beauty products, where Boots made pots of money, meant less room for, say, audio equipment, where it made little. Within the beauty-products category, it turned out that the Boots brand had as much value as Lancôme or Lauder or any other—and had the additional advantage of being a brand no other store could carry. Hence the decision to invest strongly in research and manufacturing.

It was a fundamental strategic shift—and it sortakinda just happened. As Kontes puts it: "Strategy is in the details. It's in getting the details right year in and year out; it's a thousand different decisions." Along the way there were many big choices—exiting ethical drugs, revamping manufacturing facilities for beauty products, and so on. But there was no grand strategic plan, except the seemingly simple one of subjecting all decisions to the test of maximizing shareholder value; it's as if, by changing one pixel at a time, the color of the company changed utterly. Says Lord Blyth: "We never had any lack of ideas; now we had a system that helped us make better decisions."

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The Marakon program is a relentless search for ways to use advantages in cost, service, or any other area to make a lot more money per unit of input than the competition does. When you succeed, says Kontes, "it's very hard for the other guy to figure out how you're doing it." He and McTaggart believe the secret is always the same: The only comparative advantage is management. Capital is a commodity. An organization's collective ability to outthink its rivals is not. "An advantage in productivity gets competed away very quickly," says McTaggart, "but organizational advantage is impossible to replicate. This advantage accumulates over time, and because it's a skill, it gets easier and easier to increase the advantage."

Characteristically, Marakon seeks to build that skill one element at a time. There's fact gathering, the foundation skill and one that is surprisingly rare in many companies. There's target setting. There's business modeling: learning to choose which customers, which products, and how to build strategy out of details. The capstone skill, the one Marakon hopes to leave behind when the memory of empty pizza boxes is long gone, is agenda management: the ability to identify the "highest value at stake" issues, starting at the top of the organization, then spill the process all the way down.

The Marakon program has weak points. As Carbone points out, it's tough on a young business that's still forming its capital, and also on an acquisition, because the capital cost—including goodwill—tends to land on the books before the benefits do. By its nature too, Marakon's process—starting with costs, restructuring businesses to get their economics right, judging alternative strategies against strict standards—is better at uncovering wealth buried in existing businesses than at discovering new worlds of opportunity. To a grand strategist like Gary Hamel, CEO of Strategos, managing for economic profit is well and good, but it's not news: "Teaching remedial finance to middle managers isn't very exciting. My argument is that only nonlinear strategies"—strategic leaps, not steps—"give you a chance to create new wealth."

And it's an awful lot of work. One high-value-at-stake item on Marakon's own agenda is to raise its profile so as to compete more successfully in a murderous recruiting market, and also to increase the overall size of the firm. But nothing, they swear, will persuade them to compromise the singular integrity of their offer. Value-based management—VBM, they call it—is all-consuming. "We could invent a VBM Lite and make a lot of money," Kontes says, "but you know it's not in the genes."

As monomanias go, theirs isn't a bad one. ■

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