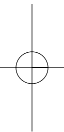
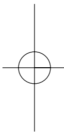
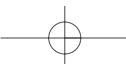
MARKETING WARS

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 10







009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 11

CHAPTER TWO

Burger Wars: McDonald's vs. Burger King, Yum et al.

Few business firms anywhere in the world have been able to match the sustained growth of McDonald's. Initially, it grew with one simple product, a hamburger; while it has broadened its product mix today, it still remains uniquely undiversified. The foundation for the success has always been the most rigid standards and controls to be found anywhere. McDonald's insisted these be adhered to by all outlets, company owned as well as franchised, and therein was an enduring marketing strategy.

For decades, no competitor could match the standards of quality, service, and cleanliness that made McDonald's unique. In recent years, however, these standards and controls have slipped, while competitors countered its former advantage and became ever more aggressive. The ball game had changed, and McDonald's was struggling to keep the growth mode. One McDonald's CEO went on a new-store binge, but these new stores often cannibalized older outlets; another CEO embarked on a crusade to acquire other fast-food restaurants, but these proved a drain on profits. Then Jim Cantalupo took the company back to basics, and the company's fortunes turned around.

An ill wind now seemed to beset McDonald's. Cantalupo, 60, the savior, died suddenly of a heart attack. His successor was diagnosed with colon cancer shortly after taking office.

But before we get into that, let's see how McDonald's got started and the glorious decades that were to come as it dominated the fast-food industry.

RAY KROC'S DREAM

Ray Kroc faced a serious dilemma. He was 57 years old and all his life had dreamed of becoming rich, and worked hard at it, but real success eluded him. He had played piano with dance bands, then turned to selling paper cups for a firm called Lily-Tulip. He also moonlighted by working for a Chicago radio station, accompanying singers and arranging the music programs. Then he thought he might make his fortune by selling land in a Florida land boom. But that did not work out, and a year later he

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 12

returned to Chicago almost broke. Lily-Tulip gave him back his old job, and he stayed there more than ten years.

In 1937, Kroc became intrigued with a new gadget, a simple electrical appliance that could mix six milkshakes at the same time. He quit Lily-Tulip again and made a deal with the inventor. He soon became the world's exclusive agent for the Prince Castle Multi-Mixer and for the next 20 years traveled all over the country peddling it. Though he didn't yet know it, at long last he was on the threshold of his dream.

In 1954, Kroc received an order for eight of the Multi-Mixers from a small hamburger stand in San Bernardino, California. He wondered what wild kind of business sold so many milkshakes. He decided to go and see for himself the operation of Maurice and Richard McDonald that needed to make 48 milkshakes at the same time.

When Ray Kroc arrived, he was amazed. It was a self-service hamburger stand, and he saw crowds of people waiting in line under golden arches. He was even more impressed with the speed of service and the cleanliness. Kroc badly wanted in on this business and hounded the McDonald brothers until they allowed him to start selling franchises. By 1960, he had sold some 200 franchises.

Kroc bought out the McDonald brothers, though he kept their name, and they took their money and quietly retired to their hometown of Bedford, New Hampshire. Once in control, it took Kroc only 17 years to reach the billion-dollar milestone. It gave him great satisfaction to think that IBM had needed 40 years to do this. Kroc would boast in his autobiography that the company was responsible for making more than 1,000 millionaires—the franchise holders.[1]

When Kroc retired in 1968, the company had more than 1,200 restaurants, and sales were $400 million. He had laid the foundation for great growth; by 1972, the number of outlets had climbed to 2,272, and sales were accelerating beyond $1 billion.

THE McDONALD'S GROWTH MACHINE

In its *1995 Annual Report,* McDonald's management was justifiably proud. Sales and profits had continued the long trend upward and even seemed to be accelerating. See Table 2.1 for sales and profits through 1998. Far from reaching a saturation point, the firm was opening more restaurants than ever, some 2,400 around the world in 1995, up from 1,800 the year before. "We plan to add between 2,500 and 3,200 restaurants in both 1996 and 1997, with about two thirds outside the United States. In other words, we opened more than six restaurants per day in 1995; over the next two years, we plan to open eight a day."[2] And, "Our growth opportunities remain significant: on any given day, 99 percent of the world's population does not eat at McDonald's … yet."[3]

[1] Ray Kroc and Robert Anderson, *Grinding It Out: The Making of McDonald's* (New York: Berkley Publishing, 1977), p. 200.

[2] *McDonald's 1995 Annual Report,* p. 8.

[3] Ibid, p. 7.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 13

TABLE 2.1 Growth in System-wide Sales and Profits, 1985–1998

	Sales (millions)	Percentage Gain	Income (millions)	Percentage Gain
1985	$11,011		$ 433	
1986	12,432	12.9	480	12.2
1987	14,330	15.3	549	14.4
1988	16,064	12.1	646	17.7
1989	17,333	7.9	727	12.5
1990	18,759	8.2	802	10.3
1991	19,928	6.2	860	7.2
1992	21,885	9.8	959	11.5
1993	23,587	7.8	1,083	12.9
1994	25,987	10.2	1,224	13.0
1995	29,914	15.1	1,427	16.6
1996	31,812	6.3	1,573	10.2
1997	33,638	5.7	1,642	4.3
1998	35,979	6.9	1,550	–5.6

Source: 1998 McDonald's Annual Report

Note: Systemwide sales include sales by all restaurants, whether operated by the Company, franchisees, or by affiliates operating under joint-venture agreements.

Commentary: Of particular interest is how the new expansion policies brought a burst of revenues and profits in the mid-l990s. But after 1995, growth in sales and earnings slowed. Note the first decline in profit gain in 1998, a harbinger of things to come.

Company management extolled the power of the McDonald's brand overseas, and how on opening days lines were sometimes "miles" long. "Often our challenge is to keep up with demand. In China, for example, there are only 62 McDonald's to serve a population of 1.2 billion."[4] By the end of 1995, the company had 7,012 outlets in 89 countries of the world, with Japan alone having 1,482. Table 2.2 shows the top-ten countries in 1999 in number of McDonald's units.

Sometimes in marketing its products in different cultures, adjustments had to be made. Nowhere was this more necessary than in Yugoslavia during the NATO bombings in the Kosovo confrontation. The following Information Box describes the changes McDonald's made there for these turbulent times.

Growth Prospects in the United States

In 1995, with 11,368 of its restaurants in the United States, wasn't McDonald's reaching saturation in its domestic market? Top management vehemently disputed this conclusion. Rather, it offered a startling statistical phenomenon to support accelerating expansion. Called "Greenberg's Law," after newly appointed McDonald's U.S. chairman Jack Greenberg, it maintained that the more stores

[4] Ibid.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 14

TABLE 2.2 Top Ten Foreign Markets in Number of Units as of Beginning of 1999

Japan	2,852 restaurants
Canada	1,085
Germany	931
England	810
France	708
Brazil	672
Australia	666
Taiwan	292
China	220
Italy	201

Source: McDonald's 1998 Annual Report

Commentary: Is the popularity in Japan a surprise?

INFORMATION BOX

MCDONALD'S SUCCESSFUL ADVENTURES IN SERBIA, 1999

The NATO air war against Yugoslavia lasted 78 days. At first, the fifteen McDonald's restaurants in Yugoslavia were closed due to angry mobs bent on vandalizing. Fanned by media attacks on "NATO criminals and aggressors," mobs of youth smashed windows and painted insults. But the restaurants soon reopened, downplaying the U. S. citizenship and presenting McDonald's as a Yugoslav company.

They promoted the McCountry, a domestic pork burger with paprika garnish. (Pork is considered the most Serbian of meats.) To cater to Serbian identity and pride, they brought out posters and lapel buttons showing the golden arches topped with a traditional Serbian cap called the *sajkaca.* Dragoljub Jakic, the 47-year-old managing director of McDonald's in Yugoslavia, noted that the cap "is a strong, unique Serbian symbol. By adding this symbol of our cultural heritage, we hoped to denote our pride in being a local company."[5] They also handed out free cheeseburgers at anti-NATO rallies. One restaurant's basement in Belgrade even became a bomb shelter.

The result? In spite of falling wages, rising prices, and lingering anger at the United States, the McDonald's restaurants were thronged with Serbs.

Still, McDonald's globally is a prominent symbol of American culture and attracts outbursts of anti-American sentiment. For example, in August 1999, a McDonald's in Belgium was burned down by suspected animal-rights activists. And India has seen militant critics: "They (McDonald's) are the chief killers of cows in the world. We don't need cow killers in India."[6]

[5] Robert Block, "How Big Mac Kept From Becoming a Serb Archenemy," *Wall Street Journal,* September 3, 1999, p. B3.

[6] "Delhi Delights in McMutton Burgers," *Cleveland Plain Dealer,* November 6, 1999, p. D3

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 15

Do you think McDonald's in Serbia went too far in downplaying—some would say even denying—its American roots? Did it have any other reasonable option if it were to keep operating?

If militant activists become more violent about McDonald's "conducting a global conspiracy against cows," do you think McDonald's should abandon the India market? Why or why not?

McDonald's put in a city, the more per-capita transactions will result. Thus, with two stores in a city there might be sixteen transactions per capita per year. Add two or four more stores and the transactions will not only double, or quadruple, but may even do better than that. The hypothesized explanation for this amazing phenomenon seemingly rested on two factors: convenience and market share. With more outlets, McDonald's increased its convenience to consumers and added to its market share at the expense of competitors. Hence, the justification for the expansion binge.

Aiding this domestic expansion, the company had been able to reduce the cost of building a new U. S. traditional restaurant by 26 percent through standardizing building materials and equipment and global sourcing, as well as improving construction methods and building designs. It had also found abundant market opportunities in satellite restaurants. These were smaller, had lower sales volume, and served simplified menus. This format proved cost-efficient in such nontraditional places as zoos, hospitals, airports, museums, military bases, and in retail stores such as Wal-Mart, Home Depot, and other major stores. For example, such satellite restaurants were in some 800 Wal-Mart stores by the end of 1995, with more planned. In October 1996, a McDonald's Express opened in an office building in Lansing, Michigan, perhaps a harbinger of more such sites to come.

In its eager search for more outlets, McDonald's did something it had never done before. It took over stores from weak competitors. In late summer 1996, it bought 184 company-owned Roy Rogers outlets. "Here was an opportunity that was maybe once in a lifetime," Greenberg stated.[7] Earlier the same year, it acquired Burghy's, an 80-store fast-food chain in Italy. In New Zealand, it added seventeen restaurants with the Georgie Pie chain.

The new stores being opened were seldom like the old ones. The drive-through windows generated 55 percent of U. S. sales and made fewer seats needed inside. This left more space available for gas stations or for indoor playgrounds—Ronald's Playplaces—to attract families. McDonald's made joint ventures with Chevron and Amoco to codevelop properties. It also signed an exclusive marketing deal with Disney for promoting each other's brands.

[7] Gary Samuels, "Golden Arches Galore," *Forbes,* November 4, 1996, p. 48.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 16

McDonald's has always been a big spender for advertising, and this has been effective. Even back in the 1970s, a survey of schoolchildren found 96 percent identifying Ronald McDonald, ranking him second only to Santa Claus.[8] In 1995, advertising and promotional expenditures totaled $1.8 billion, or 6 percent of sales.[9]

Factors in the Invincibility of McDonald's

Through the third quarter of 1996, McDonald's could proudly claim 126 consecutive quarters of record earnings. Since its earliest days, the ingredients of success were simple, but few competitors were able to effectively emulate them. The basic aspects were

- a brief menu, but having consistent quality over thousands of outlets
- strictly enforced and rigorous operational standards controlling service, cleanliness, and all other aspects of the operation
- friendly employees, despite a high turnover of personnel because of the monotony of automated food handling
- heavy mass media advertising directed mostly at families and children
- identification of a fertile target market—the family—and directing the marketing strategy to satisfying it with product, price, promotional efforts, and site locations (at least in the early years this meant the suburban locations with their high density of families)

However, by the end of 1996, international operations were the real vehicle of growth, providing 47 percent of the company's $30 billion sales and 54 percent of profits. Of no small concern, the domestic operation had not blossomed accordingly.

STORM CLOUDS FOR THE DOMESTIC OPERATION

Souring Franchisee Relations

In the market-share game, in which McDonald's dominated all its competitors, corporate management concluded that the firm with the most outlets in a given community wins. But as McDonald's unprecedented expansion continued, many franchisees were skeptical of headquarters' claim that no one loses when the company opens more outlets in a community because market share rises proportionately. Still, the franchise holder wondered how much his or her sales would diminish when another McDonald's opened down the street.

The 7,000-member American Franchisee Association, an organization formed to look after franchisees' rights, claimed that McDonald's operators were joining in

[8] "The Burger That Conquered the Country," *Time,* September 17, 1973, pp. 84–92.

[9] *McDonald's 1995 Annual Report,* p. 9.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 17

INFORMATION BOX

THE CONTENTMENT OF TWO McDONALD'S FRANCHISEES

In 1980, Wayne Kilburn and his wife, Mary Jane, took over the only McDonald's in Ridgecrest, California, a town of 26,000. The Kilburns prospered in the years to come. Then McDonald's instituted its "market-share plan" for Ridgecrest. Late in 1995, it put a company-owned restaurant inside the Wal-Mart. A few months later, it built another outlet inside the China Lake Naval Weapons Center. A third company-owned store went up just outside the naval base. "Basically, they killed me," *Forbes* reported Kilburn saying. And he claimed his volume dropped 30 percent.[10]

In its *1995 Annual Report,* corporate headquarters offered another view concerning franchisee contentment. Tom Wolf was a McDonald's franchisee with 15 restaurants in the Huntington, West Virginia, and Ashland, Kentucky, markets. He opened his first McDonald's in 1974, had eight by the end of 1993, and opened seven more in the next two years, including two in Wal-Mart stores and another in an alliance with an oil company; in addition he added indoor Playplaces to two existing restaurants.

Did all this investment in growth make a difference? The *Annual Report* quoted Tom: "I wouldn't change a thing. Sales are up. I'm serving more customers, my market share is up and I'm confident about the future. Customers say that the Playplaces and Wal-Mart units are 'a great idea.' The business is out there. We've got to take these opportunities now, or leave them for someone else to take."[11]

"The high growth, market-share policy should not bother any franchisee. It simply creates opportunities to invest in more restaurants." Evaluate this statement.

[10] Samuels, p. 48.

[11] *McDonald's 1995 Annual Report,* p. 32.

record numbers.[12] Other franchisees formed a clandestine group called the Consortium, representing dissidents who felt present management was unresponsive to their concerns. They remembered a kinder and gentler company. See the above Information Box for contrasting franchisee views on the high-growth market-share policy.

Other concerns of franchisees were a new set of business practices developed by corporate headquarters, known as Franchising 2000. The company claimed it instituted this as a way to improve standards for quality, service, cleanliness, and value by giving franchisees better "tools." But some saw this as a blatant attempt to gain more power over the franchised operations. One provision revived a controversial A, B, C, and F grading system, with only franchisees who received A's and B's eligible for more

[12] Richard Gibson, "Some Franchisees say Moves by McDonald's Hurt Their Operations," *Wall Street Journal,* April 17, 1996, pp. A1, A8.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 18

TABLE 2.3 Percentage of Franchised to Total Traditional Restaurants, Selected Years, 1985–1998

	1985	1992	1995	1998
Traditional restaurants				
Total	8,901	13,093	16,809	24,800
Operated by franchisees	6,150	9,237	11,240	15,281
Percentage franchised to total	69.1%	70.5	66.9	61.3

Source: Calculated from *1998 Annual Report*

Commentary: While by 1998, the ratio of franchised to total restaurants had dropped, still more than 60% were still operated by franchisees. This suggests the desirability of heeding franchisee concerns by corporate headquarters.

restaurants. Furthermore, McDonald's began using Franchising 2000 to enforce a single pricing strategy throughout the chain, so that a Big Mac, for example, would cost the same everywhere. The corporation maintained that such uniformity was necessary for the discounting needed to build market share. Those not complying risked losing their franchise.

Franchise relations should not be a matter of small concern to McDonald's. Table 2.3 shows the ratio of franchised restaurants to total restaurants up to 1998. As can be seen, franchises comprised, by far, the largest proportion of restaurants.

Menu Problems

In 1993, domestic per-store sales were increasing at a 4 percent annual rate. By the third quarter of 1996, sales had slumped to a 3 percent decrease, this being the fifth quarter in a row of declining sales. In part, this decline was thought to be attributable to older customers drifting away: "Huge numbers of baby-boomers … want less of the cheap, fattening foods at places like McDonald's. As soon as their kids are old enough, they go elsewhere."[13]

In an attempt to win more business from this customer segment, McDonald's, with a $200 million promotional blitz, launched its first "grownup taste" sandwich, the Arch Deluxe line of beef, fish, and chicken burgers. It forecast that this would become a $1 billion brand in only its first year. But before long, some were calling this a McFlop. In September 1996, Edward Rensi, head of U. S. operations, tried to minimize the stake in the new sandwich and sent a memo to 2,700 concerned franchisees, "the Arch Deluxe was never intended to be a silver bullet."[14] On October 8, Rensi was replaced by Jack Greenberg.

McDonald's domestic troubles were not entirely new. As far back as the late 1980s, competitors, including Pizza Hut and Taco Bell, were nibbling at McDonald's

[13] Shelly Branch, "McDonald's Strikes Out With Grownups," *Fortune,* November 11, 1996, p. 158.

[14] Ibid.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 19

market share, and Burger King was more than holding its own. Even the great traditional strength of McDonald's of unsurpassed controlled standards over food, service, and cleanliness seemed to be waning: A *1995 Restaurants and Institutions Choice in Chains* survey of 2,849 adults gave McDonald's low marks on food quality, value, service, and cleanliness. Top honors instead went to Wendy's.[15]

In 1991, McDonald's reluctantly tried discounting, with "Extra Value Meals," largely to keep up with Taco Bell's value pricing. But by 1995, price promotions were no longer attracting customers, and per-store sales began slumping. The new, adult-oriented Deluxe line was not only aimed at older adults, but with its prices 20 percent more than regular items, it was expected to parry the discounting.

The company previously had problems in expanding its menu. The McDLT was notably unsuccessful despite heavy promotion. Later, the low-fat McLean, an effort to attract weight-conscious adults, was a complete disaster. In fact, this beef-and-seaweed concoction sold so badly that some operators kept only a few frozen patties on hand, while others, as revealed in an embarrassing TV expose, sold fully fatted burgers in McLean boxes to the few customers asking for them.

Some years before, the company had tried, but failed, to develop an acceptable pizza product. It was also unable to create a dinner menu that would attract evening-hour traffic. Two other experiments were also abandoned: a 1950s-style cafe and a family-type concept called Hearth Express that served chicken, ham, and meatloaf.

THE SITUATION IN THE NEW MILLENNIUM

Jack Greenberg was promoted to CEO of McDonald's in August 1998, and then to chairman of the board in May 1999. There was hope that he would improve the alienation felt by many franchisees. He quickly began diversifying within the fast-food industry, buying Donatos Pizza, a midwestern chain of 143 restaurants, proclaiming: "We would like to make this a growth opportunity for our franchisees."[16] Imitating some of its competitors, particularly Wendy's, McDonald's also installed a new cooking system to deliver sandwiches to order, "Made for You," which meant fresher with less waste compared with the old system of holding bins. "You don't grow this business by having clean washrooms" Greenberg said. "We will grow this business through food."[17]

Despite Greenberg's leadership, McDonald's domestic operations continued to falter. By 2001, it was averaging only 1 percent same-store sales growth, far behind the 4 percent average of Burger King and Wendy. After 44 years as one of America's premier growth companies, market saturation seemed imminent. The main reason was thought to be a stale menu, but that was hardly a new insight.

Of perhaps just as much concern was the deterioration of the stringent controls that for decades had marked McDonald's as the paragon among all firms. A 2001

[15] Ibid.

[16] James P. Miller and Richard Gibson, "Did Somebody Say Pizza?" *Wall Street Journal,* May 1, 1999, p. A4.

[17] Kevin Helliker and Richard Gibson, "The New Chief is Ordering Up Changes at McDonald's," *Wall Street Journal,* August 24, 1998, p. B4.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 20

University of Michigan study on customer satisfaction showed that conditions had worsened from the 1995 survey that had given it low marks on food, service, and cleanliness. This 2001 study also ranked McDonald's among the poorest-performing fast-food chains, with 11 percent of customers dissatisfied because of slow service, wrong orders, dirty stores, and rude, uncaring employees. Estimates were that unhappy customers could mean an average of $60,000 in lost sales per year per store. In efforts to improve customer satisfaction, "customer recovery teams" were planned, along with better education of store managers and franchisees in handling complaints.[18]

Undoubtedly, such problems reflected the difficulty many businesses were having in hiring good help in the low unemployment of the late 1990s. But other fast-food chains were doing better in this regard than McDonald's. Perhaps another factor contributed to the quality control problems. In recognition of franchisee complaints, Greenberg threw out the Franchise 2000 rulebook with its 80 pages of onerous regulations and gave franchisees more say in their local menus.

The frenetic growth in outlets of the mid-1990s was over, as many angry franchisees had seen their sales decline as much as 30 percent due to cannibalization by nearby McDonald's outlets. In 1999, only 150 new outlets were added, down sharply from the 1,100 of a few years before.

Increasingly, Greenberg turned his attention to food diversifications. He planned to grow the 143-store Donatos Pizza regional chain to a national one of a thousand stores. He bought into Chipotle Mexican Grill, a popular Denver-based chain of Mexican restaurants. The purchase of Aroma, a coffee-and-sandwich bar in London, England, showed perhaps the most promise. In the UK, the cold-sandwich market was almost double the size of the burger market and growing twice as fast, appealing to a mostly single, health-conscious, and female customer base that had practically no overlap with the burger crowd—therefore, no cannibalization. Some 150 Aroma stores were planned by 2002. In another major acquisition, McDonald's acquired the faltering Boston Market chain on May 26, 2000. About 100 underperforming Boston Market restaurants were closed, and others were converted to McDonald's, Chipotle Mexican Grill, and Donatos Pizza. This still left more than 750 Boston restaurants that could challenge McDonald's management in achieving profitability.

In a major menu thrust beyond burgers, more new products were coming out of McDonald's test kitchens than ever before, many of these appealing regionally rather than nationally. For example, the McBrat, a $1.99 sandwich with sauerkraut and onion on a bratwurst, a big hit in Minnesota and Wisconsin; the McLobster Roll in New England; the Homestyle Burger with hot mustard in Texas; the Brutus Buckeye Burger for Ohioans; and even bagel breakfast sandwiches, were already doing well in 6,000 stores.[19]

Still, U.S. sales grew just 3 percent in 2000, while fourth-quarter net earnings declined 7 percent. McDonald's responded with the "New Tastes Menu," a collection of 44 items to be rotated four at a time. An analyst noted, however, that these were

[18] Richard Gibson, Dow Jones News, as reported in "McDonald's Leaders Finding Rudeness, Slowness Are Costing Company Business," *Cleveland Plain Dealer,* July 16, 2001, p. C6.

[19] Bruce Upbin, "Beyond Burgers," *Forbes,* November 1, 1999, pp. 218–223.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 21

mostly "tired old products with such startling innovations like a strip of bacon or a dollop of ranch dressing."[20]

The Situation in the Rest of the World

In Europe, mad-cow hysteria and currency woes were playing havoc, and McDonald's stock was at a two-year low. But non-U.S. restaurants continued to offer the best opportunities, and by the end of 2000, foreign restaurants outnumbered U.S. outlets by 15,900 to 12,408. International business contributed 52 percent of total operating income by 2000. (Company public information.) The success of the international operations partly reflected McDonald's adaptations in foreign environments. (We saw an example of this earlier in the Serbian Information Box.)

Japan, especially, was a lucrative foreign market, and by 2001 the almost 3,600 McDonald's had changed the eating habits of the nation, making fast food a part of everyday life. McDonald's—*Maku* in Japanese shorthand—controlled about 65 percent of the fast-food burger market, serving 1.3 billion customers a year. The mad-cow scare, that had so severely affected demand in Europe, was at first largely averted in Japan, which used beef from Australia where there had been no disease. Later, the stigma also began to affect Japanese demand.

LATER DEVELOPMENTS

CEO Jack Greenberg, now 60, stepped down at the end of 2002, well ahead of his planned 2005 retirement. His had been a frustrating four-year effort to reinvent the firm and start it on a new growth pattern.

Greenberg's reinvention efforts included starting a fierce price war by selling two of McDonald's biggest sandwiches for $1 each, introducing some forty menu items, spending $151 million to overhaul the company's U.S. kitchens in order to make food hotter and fresher, and acquiring other restaurant chains. In November 2002, customers were even given the option of paying with credit cards and earning frequent flyer miles. Still, sales had remained lackluster, and profits fell in seven of the past eight quarters, while the stock price had sunk to a seven-year low.

Aside from the acquisitions, customer response to most of these efforts was poor. The price war mostly resulted in all burger chains facing lower profits with little increase in sales. The new "Made for You" kitchens sacrificed speed and service. And Greenberg could never bring customer service up to historic levels, despite sending mystery shoppers to evaluate service. The mad-cow scare in Europe in 2000 dragged down profits as well, but profitability was not regained with the end of mad-cow concerns.[21]

The foreign markets that had long sustained the growth mode were also faltering now. Germany was the largest European market, but McDonald's growth there stagnated as competition grew from Burger King, which expanded in Germany from

[20] Brandon Copple, "Same Old, Same Old," *Forbes,* February 19, 2001, p. 60.

[21] Shirley Leung and Ron Lieber, "The New Menu Option at McDonald's: Plastic," *Wall Street Journal,* November 26, 2002, pp. D1–2; Shirley Leung, "McDonald's Chief Plans to Leave," *Wall Street Journal,* December 6, 2002, pp. A3, A6.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 22

268 stores in 2000 to 390 in 2002, and from local retailers such as gas-station food marts and traditional mom-and-pop bakeries. In the UK, McDonald's problems with service, cleanliness, and changes in consumer tastes now throttled its expansion efforts. In Japan, long the crown jewel in McDonald's foreign operations, the chain's 3,800 stores faced a saturated market, with its core customers—families with children—shrinking from a declining birthrate, while local competitors became stronger. Same-store sales in Japan fell 12.1 percent in 2002 and were expected to fall an additional 3.5 percent in 2003.

Domestically, even the restaurant chains that Greenberg acquired in his diversification efforts were not producing the expected profits. Boston Market and its partner brands, as a group, lost $67 million on sales of $1.07 billion in 2002. Some of these could face divestiture by a top management that is less growth minded.

James R. Cantalupo

Cantalupo succeeded Greenberg as CEO in January 2003. Recently retired as CEO of McDonald's International, his job now was to restore sales and profit growth company-wide. With his arrival, the company announced its first quarterly loss since going public in 1965, almost forty years before.

When the board brought him back to replace Greenberg, Cantalupo acted quickly to undo some of the high-profile projects of his predecessor. He killed a $1 billion technology effort, code named Innovate, that had been envisioned to be a global digital network linking 30,000 McDonald's restaurants to headquarters and vendors. "We know we need to make changes," Cantalupo said, but "We don't intend to throw capital at problems."[22] In his letter to shareholders for the *2002 McDonald's Annual Report,* Cantalupo announced

> We are targeting a lower earnings growth rate. Given the nature and size of our business, the prior earnings per share growth target in the 10 percent to 15 percent range is no longer realistic … in short, McDonald's is in transition from a company that emphasizes *adding restaurants to customers* to one that emphasizes *adding customers to restaurants.*[23]

He made investors happy by slashing capital spending by 40 percent, largely, through closing poorer performing restaurants and adding fewer new restaurants. He also raised the dividend 70 percent.

Cantalupo and his team addressed mounting customer complaints about slow drive-through service and surly employees. Efforts were made to improve the taste of burgers and promote salad entrees, while eliminating "super size" french fries and soft drinks—these latter two menu moves designed to placate critics blaming obese consumers on burger sellers.

[22] Richard Gibson and Steven Gray, "Death of Chief Leaves McDonald's Facing Challenges," *Wall Street Journal,* April 20, 2004, p. A16.

[23] *McDonald's 2002 Annual Report,* p. 3.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 23

The attractiveness of the new low-growth policy of Cantalupo was fully evident in the summer and fall of 2003 when the stock price rose from $18 to over $24 by early October.

On April 19, 2004, a calamity of no small moment occurred. At a global convention of McDonald's franchisees in Orlando, Florida, just before he was to make the opening remarks about his successful 16-month campaign to restore sales and profit growth, Jim Cantalupo collapsed and died of an apparent heart attack. McDonald's board quickly named 43-year-old Charlie Bell to the top job. Bell was an obvious choice, having been president and chief operating officer since late 2002.

Then the company faced an almost unbelievable double whammy, when soon after Bell was named CEO, he was diagnosed with colon cancer and had to resign in November to focus on battling the disease.

RESURGING COMPETITORS

By 2003, McDonald's faced increased competitive pressure, although it still dominated the fast-food industry. One firm in particular, Yum Brands, had become a major factor in the fast-food industry. Table 2.4 shows the relative competitive positions of McDonald's and its major competitors as of 2003. Burger King had long been the closest competitor in size, but now Yum had more restaurants than McDonald's, although McDonald's still was the big leader in total revenues.

Burger King

Interestingly, the origins of Burger King and McDonald's were almost the same year. Burger King was founded in 1954, in Miami, by James McLamore and David Edgerton. Ray Kroc founded McDonald's one year later. As can be seen from Table 2.5, Burger King grew far slower than McDonald's, despite being a little older. In 1967, it had 8,000 employees in 274 restaurants when Pillsbury Company acquired it for $18 million.

TABLE 2.4 Competitive Positions of McDonald's and Major Competitors 2003[a]

	System-wide Sales	Net Income	No. of Stores
McDonald's	41.5	1.5	31,129
Yum	8.9	.7	33,000
Burger King	11.1	N.D.	11,223
Wendy's	3.1	.24	9,291

[a] In billions of dollars.

Sources: Company annual reports; N.D. not disclosed,

Commentary: You can see the still commanding position of McDonald's despite its lessening growth mode. At this point, the consolidation of five restaurant brands—four of these, KFC, Pizza Hut, Taco Bell, and Long John Silver's, being the global leaders of the chicken, pizza, Mexican-style food, and quick-service seafood categories—under the Yum umbrella, makes rapidly growing Yum perhaps the major competitor of McDonald's, even though Burger King still has the second place in sales.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 24

TABLE 2.5 Competitive Position of Burger King and McDonald's in Total Sales and Restaurants, 1993–1998

	Total Sales (billions of $)					
	1993	1994	1995	1996	1997	1998
McDonald's	23.6	26.0	29.9	31.8	33.6	36.0
Burger King	6.7	7.5	8.4	9.0	9.8	10.3
Percentage of McDonald's	28.4%	28.0	28.1	28.3	29.2	28.0
	Total Restaurants (hundreds)					
McDonald's	14.2	15.9	18.4	21.0	23.1	24.8
Burger King	7.1	7.5	8.0	8.7	9.4	9.8
Percentage of McDonald's	50.0%	47.1	43.5	40.0	40.7	39.5

Sources: Calculated from company reports.

Commentary: You can see in these years that Burger King was unable to gain any ground on McDonald's except one year, 1997, in total sales. In number of restaurants, it steadily lost ground as McDonald's opened far more restaurants than ever before. This suggests the power position of the firm with greater size and resources.

Despite slower growth, Burger King was the first in the industry to introduce dining rooms where patrons could sit inside to devour their burgers and fries. In 1975, it was the first to introduce drive-through service, and this came to account for 50 percent of Burger King's business. McDonald's and other fast foods were quick to adopt these concepts.

In 1988, Grand Metropolitan PLC, an English firm, acquired Pillsbury and its Burger King. In 1997, Grand Metropolitan merged with Guinness to create Diageo, which in addition to owning Burger King also had such well-known consumer brands as Guinness Beer, Pillsbury, Green Giant, Haagen-Dazs, Smirnoff Vodka, and J & B Scotch Whiskey. As of April 1999, Burger King had 10,506 company-owned and franchised restaurants in all 50 states and 54 countries around the world, with sales of $10.3 billion. In December 2002, Diageo sold Burger King for $1.5 billion to a venture capital consortium led by Texas Pacific Group. In fiscal year 2003, Burger King had systemwide sales of $11.1 billion, and 11,223 total worldwide outlets.

Yum Brands

PepsiCo had spun this organization off in 1997, and it was now the world's largest restaurant operator in units, with 33,000 restaurants in five major chains: Pizza Hut, Taco Bell, KFC (Kentucky Fried Chicken), Long John Silver's, and A&W All-American Food. Yum CEO, David Novak, blamed the problems that led to the spin-off on PepsiCo's mismanagement and emphasis on marketing to the neglect of quality, service, and atmosphere. In 2002, the company changed its name to Yum Brands, from Tricon Global Restaurants, to reflect its expanding portfolio of brands and its ticket symbol on the New York Stock Exchange. Four of the company's restaurant brands—KFC, Pizza Hut, Taco Bell, and Long John Silver's—were the global leaders of the chicken, pizza, Mexican-style food, and quick-service seafood categories.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 25

Wendy's

Wendy's worldwide sales were $3.1 billion in 2003, and it had 9,291 restaurants. It was founded in 1969 by Dave Thomas, well known from being the spokesman in TV commercials, until his death. Recently, the company began bringing back some of his old commercials. Wendy's has invested in Tim Hortons, the largest coffee and fresh baked goods restaurant chain in Canada; Baja Fresh Mexican Grill; Café Express, a bistro-style restaurant; and Pasta Pomodoro Italian style restaurants.

ANALYSIS

After decades of uninterrupted growth in sales, profits, and number of stores opened, McDonald's faced diminished prospects, domestically and foreign, by the latter 1990s. Though no one wanted to admit it then, the evidence was rather compelling that the company life cycle was reaching maturity without major policy changes. Pouring more efforts into additional outlets seemed ill advised, although it took a new CEO to recognize and come to grips with this. But the siren call of growth is difficult to subdue.

Relations with franchisees, formerly best in the industry, had deteriorated as corporate management pursued policies more dictatorial and selfish than ever before, policies that signaled the end of the kinder and gentler stance franchisees remembered. In particular, the new expansion policy aimed at increased market share, regardless of its effect on established franchisees, portended worsening relations and the start of an adversarial instead of supportive climate.

The cost-benefit consequences of an aggressive expansion policy were rationalized as in the company's best interest, especially as recent store construction became more cost-efficient. If total market share could be substantially increased, despite same-store sales declining, the accounting analyses supported more stores. But how much should the franchisee be considered in this aggressive strategy of McDonald's outlets competing, not so much with Wendy's, Burger King, and Taco Bell, as with other McDonald's outlets? And couldn't profitability be improved by more carefully selecting fewer new store sites and, at the same time, identifying marginal stores that perhaps should be closed?

A major domestic challenge for the growth-oriented McDonald's was the menu: how to appeal to adults and expand market potential. This offered another growth alternative, even more so, if the dinner market could be tapped. But the last successful menu expansion had been the breakfast menu, and that was decades ago.

What menu changes should be made? Installing a salad bar—would this be the menu breakthrough needed? With a history of past failures, expectations could hardly be robust. Yet McDonald's, as any chain organization whether fast food or otherwise, can test different prices and strategies or different menus and atmospheres in just a few outlets and, only if results are favorable, expand further. A few stores then can provide a powerful research tool.

A major trouble spot was McDonald's seeming inability to enforce tighter controls over product quality and service. The rigid standards and controls imposed in the days of Ray Kroc, that made McDonald's unique, had somehow eroded. Admittedly, as

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 26

more and more outlets were added, enforcing tight controls became more difficult. Yet competitors, meantime, were doing a better job of matching, and surpassing, McDonald's former high standards. And the profit picture and shareholder attitudes were ever worsening. The glory days seemed only a pleasant memory.

Into this breach came a white knight. In less than 16 months, Jim Cantalupo, with an espoused low-growth strategy, had turned things around. But then he died suddenly of a heart attack. The new CEO, a month after assuming the office, was diagnosed with colon cancer and a few months later had to resign.

WHAT CAN BE LEARNED?

It is Possible to Have Strong and Enduring Growth Without Diversification

For more than four decades, since 1955, McDonald's had grown continuously and substantially. In all this time, the product was essentially the hamburger in its various trappings and accompaniments. Almost all other firms, in their quest for growth, have diversified, sometimes wisely and synergistically, at other times imprudently and even recklessly.

For such an undeviating focus, the product should have universal appeal, be frequently consumed, and have almost unlimited potential. The hamburger probably meets these criteria better than practically any other product, along with beer, soft drinks, and tobacco. And soft drinks, of course, are a natural accompaniment of the hamburger.

Eventually, even the hamburger began to fall short in providing continued strong growth, as the international market reached saturation and the domestic market oversaturation. McDonald's may be forced to seek judicious diversifications or lose the growth mode. There is risk: Firms in pursuit of growth often jump into acquisitions far too hastily and are faced with massive debt and overhead. And most of McDonald's present diversifications have not met their expectations.

Beware the Reckless Drive for Market Share

A firm can usually "buy" market share, if it is willing to sacrifice profits to do so. It can step up advertising and sales promotions. It can reduce prices, assuming that lower prices would bring more demand. It can increase sales staff and motivate them to be more aggressive. Sales and competitive position then will usually rise. But costs may increase disproportionately. In other words, the benefits to be gained may not be worth the costs.

As we saw, McDonald's aggressively increased market share in the mid-1990s by opening thousands of new domestic units. As long as developmental costs could be kept sufficiently low for these new units to be profitable and not cannibalize business from other McDonald's restaurants, then the strategy was defensible. Still, the costs of damaged franchisee relations resulting in lowered morale, coop-

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 27

eration, and festering resentments could be real indeed. Interestingly, this market share growth strategy was toned down by early 2000.

Maintaining the Highest Standards Requires Constant Monitoring

McDonald's heritage and its competitive advantage had long been associated with the highest standards and controls for cleanliness, fast service, dependable quality of food, and friendly and well-groomed employees. The following Information Box discusses strategy countering by competitors and the great difficulty in matching nonprice strengths.

Alas, in the last few years McDonald's has apparently let its control of operational standards slip. We have seen that surveys of customer satisfaction in 1995 and 2001 gave McDonald's low marks on food quality, value, service, and cleanliness, with its competitors showing up considerably better. Why this lapse? Without a doubt, maintaining high standards among thousands of units, company owned as well as franchised, requires constant monitoring and exhortation. But this was successfully done for over four decades. How was this lapse allowed to happen? We can only speculate that such standards became taken for granted, not emphasized as much. Then it became difficult to resurrect them.

Controls Can Be Too Stringent

In a belated attempt to improve standards and tighten corporate control, McDonald's instituted the controversial Franchising 2000. Among other things,

INFORMATION BOX

MATCHING A COMPETITOR'S STRATEGY

Some strategies are easily countered or duplicated by competitors. Price cutting is the most easily countered. A price cut can often be matched within minutes. Similarly, a different package or a warranty is easily imitated by competitors.

But some strategies are not so easily duplicated. Most of these involve service, a strong and positive company image, or both. A reputation for quality and dependability is not easily countered, at least in the short run. A good company or brand image is hard to match because it usually results from years of good service and satisfied customers. The great controls of McDonald's, with its high standards, would seem to be easily imitated, but they proved not to be, as no other firm fully matched them until recent years.

The strategies and operations most difficult to imitate often are not the wildly innovative ones, nor the ones that are complex and well researched. Rather they seem to be the simple ones: doing a better job in servicing and satisfying customers and in performing even mundane operations cheerfully and efficiently.

What explanation can you give for competitors' inability, for so long, to match the standards of McDonald's?

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 28

this called for grading franchisees, with those receiving the lower grades being penalized. McDonald's also wanted to take away any pricing flexibility for its franchisees: All restaurants now had to charge the same prices or risk losing their franchise. Not surprising, some franchisees were concerned about this new "get tough" management.

Can controls be too stringent? As with most things, extremes are seldom desirable. All firms need tight controls over far-flung outlets to keep corporate management alert to emerging problems and opportunities and maintain a desired image and standard of performance. In a franchise operation, this is all the more necessary since the company is dealing with independent entrepreneurs rather than hired managers. However, controls can be so rigid that no room is left for special circumstances and opportunities. If the enforcement is too punitive, the climate becomes more that of a police state than a teamwork relationship with both parties cooperating to their mutual advantages.

This brings us to the next insight for discussion.

There is Room for a Kinder, Gentler Firm in Today's Hotly Competitive Environment

Many longtime McDonald's franchisees remembered with sadness a kinder, gentler company, an atmosphere nurtured by founder Ray Kroc. To be sure, Kroc insisted that customers be assured of a clean, family atmosphere with quick and cheerful service. To Kroc, this meant strict standards, not only in food preparation but also in care and maintenance of facilities, including toilets. Company auditors closely checked that the standards were adhered to, under Kroc's belief that a weakness in one restaurant could have a detrimental effect on other units in the system. Still, the atmosphere was helpful—the inspectors were "consultants"—rather than adversarial. Kroc was proud that he was responsible for making more than 1,000 millionaires, the franchise holders.

Many franchisees traced the deterioration of franchiser-franchisee relations to the 1992 death of Gerald Newman, McDonald's chief accounting officer. He spent much time interacting with franchisees, sometimes encouraging them—he had a reputation for a sympathetic ear—sometimes even giving them a financial break.[24]

So, is it possible and desirable to be a kind and gentle company? With franchisees? Employees? Suppliers? Customers? Of course it is. Organizations, and the people who run them, often forget this in the arrogance of power. They excuse a "get tough" mind-set on the exigencies of competition and the need to be faithful to their stockholders.

Kind and gentle—is this an anachronism, a throwback to a quieter time, a nostalgia long past its usefulness? Let us hope not.

[24] Gibson, p. A8.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 29

Any Firm Needs Contingency Planning, Especially with Regard to Succession

The improbable catastrophe that beset McDonald's—losing two CEOs to death and severe illness in only a few months—graphically shows the need for successor planning in developing understudies who can step in quickly, if necessary, to continue the momentum and successful policies. It also should raise a caution: Since accidents do happen, company policies should prohibit top executives all flying on the same plane—perhaps a corporate jet—or being in the same car. Insurance policies also can offer some protection against financial loss should major executives be unexpectedly incapacitated.

CONSIDER

Can you add other learning insights?

QUESTIONS

1. How do you account for the reluctance of competitors to imitate the successful efforts of another firm in their industry? Under what circumstances is imitation likely to be embraced?
2. To date, McDonald's has shunned diversification into unrelated food retailing operations as well as nonfood options. Discuss the desirability of such diversification efforts.
3. "Eventually—and this may come sooner than most think—there will no longer be any choice locations anywhere in the world for new hamburger outlets. As a McDonald's stockholder, I'm getting worried." Discuss.
4. Does the size of McDonald's give it a powerful advantage over its competitors? Why or why not?
5. What do you think is McDonald's near-term and long-term potential? What makes you think this?
6. Is it likely that McDonald's has really found a saturated market for its hamburgers?
7. Discuss the importance of market share in the fast-food industry.
8. Discuss the desirability of McDonald's efforts to insist on the same price in all domestic restaurants.
9. Do you think McDonald's "adaptability" in such countries as Yugoslavia went too far in repudiating U. S. values? Why or why not?

HANDS-ON EXERCISES

1. You have been given the assignment by Edward Rensi in 1993 to instill a recommitment to improved customer service in all domestic operations.

009-30.Hartley_mk_10e.Ch02_P1 9/28/05 7:04 PM Page 30

Discuss in as much detail as you can how you would go about fostering this among the 10,000 domestic outlets.

2. As a McDonald's senior executive, what long-term expansion mode would you recommend for your company?
3. As a Burger King senior executive, what long-term expansion mode would you recommend for your company to combat a McDonald's growth machine that has maybe grown a bit vulnerable?
4. Be a Devil's Advocate (and argue a dissenting view). Develop all the persuasive arguments you can that Cantalupo's limited expansion policies will doom the company's growth and invite competitive inroads.

TEAM DEBATE EXERCISES

1. Debate this issue: McDonald's is reaching the limits of its ability to grow without drastic change. (Note: The side that espouses drastic change should give some attention to the most likely directions for such, and be prepared to defend these expansion possibilities.)
2. Debate the issue of a "get-tough" attitude of corporate management toward franchisees even if it riles some, versus involving them more in future directions of the company. In particular, be prepared to address the challenge of bringing customer satisfaction up to traditional standards.
3. Debate this contention: Market share is overemphasized in this industry. (Both sides in their debate may want to consider whether this assertion may or may not apply to other industries.)

INVITATION TO RESEARCH

How have Cantalupo's slower growth policies fared since he is no longer with the company? Has growth in profitability continued? How about the company stock market valuation? Has McDonald's made any major acquisitions recently? Has Yum continued creeping up on McDonald's?