

# THE MCDONALD'S CASE: STRATEGIES FOR GROWTH

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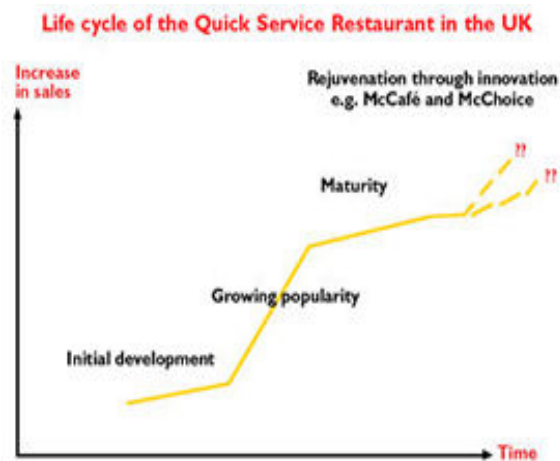
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**Abstract:** This paper presents a case study of international franchising, focusing on fast-food sector. McDonald's is one of the world's premier entrepreneurial success stories. However, early in 2003, McDonald's has announced a re-structure plan including cutting jobs, closing many restaurants and slowing down the expansion plan. What went wrong with McDonald's and what can other international franchises learn from these mistakes are investigated. Result shows business environments, corporate level strategies, and operations are the key issues.

**Keywords:** McDonald's, international franchising, fast food.

In a global scale, the fast-food industry is facing some serious threats. First, the fast-food market has reached the boiling point in most of the main market such as United States, Germany, and United Kingdom. The war price of fast-food giants is a clear example of market saturation, for example, Wendy's chain has introduced a lowest ever price value meal: 99p. In terms of the [product life cycle](#), quick service restaurants have reached [maturity](#) stage. Figure one illustrates the life cycle of quick service restaurant in United Kingdom.



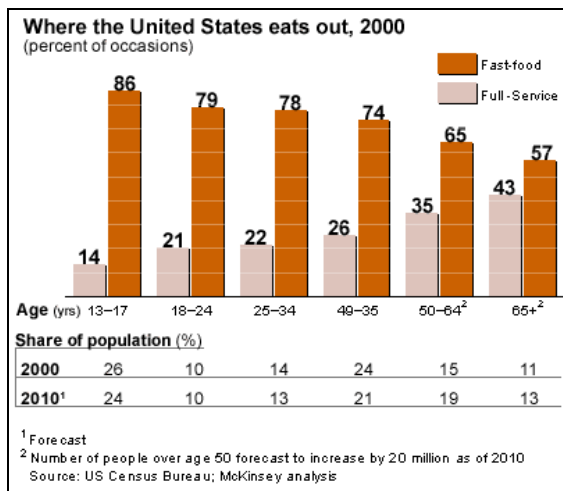
\* Source: <http://www.thetimes100.co.uk/>

**Figure 1. Quick Service Restaurant Product Life Cycle**

Second, rising incomes allow people more opportunities to turn eating out into a more individualised experience rather than a routine 'quick fix'.

In United Kingdom, market research reveals that the total number of meals eaten in the non-quick service restaurant sector has risen while meals eaten in the Quick Service Restaurant sector have fallen in total (The Times 100, 2003). In United States, the situation is quite similar. According to a new McKinsey study, the fast-food industry will grow by only 1% a year during the next eight years--less than half the current rate. In contrast, full-service restaurants will see annual increased sales of 3.2%. In sum, sit-down eateries will see \$42 billion in new revenue over the next eight years compared with \$13 billion for quick-service restaurants. The rationale behind McKinsey's numbers: As they age, Americans tend to trade up from quick-service to full-service restaurants. The consulting firm said that, in 2000, Americans between the ages of 18 and 24 ate at fast-food restaurants 79% of the time and at full-service restaurants 21% of the time. Meanwhile, Americans who were 65 and older went to quick-service restaurants only 57% of the time and to sit-down restaurants 43% of the time. Headed in their direction are the Americans in the boomer demographic--ages 50 to 64--who ate at fast-food restaurants for 65% of their meals and at full-service restaurants for 35% (Figure 2).

Third, convenience food is a substitute threat for fast-food sector. Packed-food industry (Kraft, Campbell, etc.) is in head-to-head competition with fast-food industry for a bigger portion of food market. In addition, supermarkets, convenience stores, delis, and petrol stations offer more and more carry-out meals and re-heatable packaged foods.



\* Source: <http://www.businessweek.com/1998/10/b3568001.htm>

**Figure 2. Where the United States Eats Out, 2000**

Last but not least, the biggest threat appears to come from an increasing awareness among consumers of the benefits of healthy eating. Nutrition and health studies and reports have heightened public concern over the fat and sodium content of fast foods. Moreover, a Euro monitor report published in November, found that "a sandwich is viewed by the majority of consumers as an inherently healthier product than burgers, chicken, fish and chips, or many other fast-food sub-sectors. Consequently, in 1990, burger consumption dropped to 17 percent of all restaurant orders, from 19 percent in 1982 (Lewison, 1994). As the results from aforementioned unfavorable trends, sales growth has slowed in the fast-food market from 7.1 percent in the 1970s to 4.9 percent in the 1980s to 3.0 percent in 1990 (Lewison, 1994).

McDonald's is one of the world's premier entrepreneurial success stories in fast food industry. However, early in 2003, McDonald has announced a re-structure plan including cutting jobs, closing many restaurants and slowing down the expansion plan. From all phenomena mentioned above, particularly what has happened to McDonald's, what went wrong with McDonald's and what can other international franchises learn from these mistakes are investigated in this paper.

## MCDONALD'S HISTORY: GOLDEN ARCHES

*"Whatever people ate, McDonald's would be the ones to sell it"*

Ray Kroc's: McDonald's Founder

McDonald's Corporation is the world's largest chain of [fast-food restaurants](#). Although McDonald's did not invent the [hamburger](#) or the fast-food

restaurant, their name has become nearly synonymous with both. The history of McDonald's began in 1940 when brothers Dick and Mac McDonald opened the first restaurant in [San Bernardino, California](#). The McDonald's restaurant gained fame after 1948, when the brothers implemented their innovative "Speedee Service System", an [assembly-line](#) hamburger construction and [self-serve](#) operation.

In 1954, [entrepreneur](#) and [milkshake-mixer salesman](#) [Ray Kroc](#) became interested in the McDonald's restaurant when he learned of its extraordinary capacity. Upon seeing the restaurant in operation, he approached the McDonald brothers with a proposition to open new McDonald's restaurants, with himself as the first franchisee. Kroc worked hard to sell McDonald's. He even attempted to overcome on his wartime in connection with Walt Disney, in the failed hope of opening a McDonald's at the soon-to-be-opened Disneyland. Eventually he opened his first restaurant in Des Plaines, Illinois. It was an immediate success.

Kroc's new company was originally named "McDonald's Systems Inc.", and was founded [March 2, 1955](#). In 1960, the company was renamed "McDonald's Corporation". One of Kroc's marketing insights was his decision to market McDonald's hamburgers to families, and particularly to children. In the early 1960s, a [Washington, DC](#) McDonald's franchisee named Oscar Goldstein sponsored a children's show called *Bozo's Circus*, starring a clown played by [Willard Scott](#). When the show was cancelled, Goldstein hired Scott as McDonald's new mascot, "[Ronald McDonald](#)'s". The character was eventually spread to the rest of the country via an advertising campaign, although it was decided that Scott was too plump for the role. Under Kroc's agreement with the McDonald brothers, he was responsible for the entire expansion process, while the brothers retained control of the production process and a share of the profits. By 1961, Kroc was frustrated with the arrangement. After some negotiation, the comfortably wealthy McDonald brothers agreed to sell Kroc the business rights to their operation for \$2.7 million, which was borrowed from a number of [investors](#). Since that time, McDonald's has opened restaurants in countries throughout the world. On [January 31, 1990](#) the first McDonald's Restaurant opened in [Moscow, Russia](#). In contrast to the stereotype of McDonald's in the United States in which McDonald's is seen as the source of cheap, inferior, and unhealthy food, in some parts of the world such as [Russia](#) and [China](#), McDonald's food is seen as a status symbol and the restaurants are admired for their atmosphere and cleanliness (Wikipedia.com, 2003).

Today, McDonald's remains the king of fast food with 31,000 restaurants in 121 countries. In 2001, they served over 16 billion customers, equivalent to a lunch and dinner for every man, woman and child in the world! McDonald's global sales were over \$38billions, making it by far the largest food service company in the world, which made it the world's 366<sup>th</sup> largest company measured by revenues. The company operates other restaurant brands, such as [Aroma Café](#), [Boston Market](#), [Chipotle Mexican Grill](#), [Donatos Pizza](#) and [Pret A Manger](#). As part from its food, the chain is famous for the way that all staff are trained in its distinctive operating procedures, at the company's own "Hamburger University". In 2002, it was the world's 10<sup>th</sup> largest employer, with 395,000 employees worldwide (Fortune, 2002).

In term of revenue between year 2000-2003, United States' operation contributes the highest portion follows with Europe (except in 2004, Europe is at the highest share) and Asia Pacific, Middle East and Africa (Table 1). McDonald's owned 43% of the hamburger fast-food market followed by Burger King with 19% and Wendy's with 13% (Trends Setter, 2002).

**Table 1. Distribution of Revenue (dollars in millions)**

	2004	2003	2002	2001	2000
U.S.	\$6,526	6,039	5,423	5,396	5,259
Europe	6,736	5,875	5,136	4,752	4,754
APMEA	2,721	2,447	2,368	2,203	2,102
Latin America	1,007	859	814	971	949
Canada	898	778	633	608	615
Partner	1,1756	1,142	1032	940	564
Branded					
Total Revenue	19,065	17,141	15,406	14,870	14,243

\* Source: McDonald's annual report, <http://www.mcdonalds.com/>

Despite the favourable economic growth in 1980's and early 1990's, McDonald's had a precise expansion strategy from the starting point. Ray Kroc realized that the key to success was rapid expansion through internalization. The best way to achieve this was by applying forward integration strategy through offering franchises. Kotler (2003, p. 101) claimed that sales and profit of a business can be accelerated through forward integration in its industry in which it may get hold of some retailers or wholesalers, particularly they are highly profitable (franchisee). Today, over 70 percent of McDonald's restaurants are run on this basis (The Times 100, 2002). As shown in table 1, approximately above 63% of total revenue is from overseas operation. For most of the world's inhabitants, McDonald's is globalisation. To a larger

extent, McDonald's is looking for homogeneous consumer groups and replicating the same format in foreign countries, making only minor changes to suit the local or national preferences but recognizably maintaining the original concept (Helfferich *et al*, 1997). Illustration can be seen through extensive menu development in many countries for instance beside the original ones, McLarks in Norway, a grilled salmon sandwich with dill sauce on a whole grain bread, Groenteburger in the Netherlands, Samurai pork burger in Thailand, Chicken Tatsuta sandwich in Japan and many more (Ritzer, 1998).

Despite the diverse environments in which it operates and the fact that many of its restaurant are managed by franchises, until 1997 most outlets were operated using the same reward systems, the same hierarchical management structure, and the same routine for serving food. McDonald's centralized the design of its service concept, restaurant layout, the selection of franchisees and other personnel, and the design and content of training of restaurant managers and staff. The company is an enterprise with 900-page manual and 36,000 regulations for its huge number of stores. The standardization of McDonalds has been emblematic of globalisation (Love, 1986).

Adding to its success, the McDonald's Corporation's business model is slightly different from that of most other fast-food chains. In addition to ordinary franchise fees, supplies and percentage of sales, McDonald's also collects rent. As a condition of the franchise agreement, McDonald's owns the property on which most McDonald's franchises are located. The corporation extracts income from the franchises in the form of rents, which are only partially linked to sales. As Harry J. Sonneborne, one of McDonald's founders put it, "We are in the real estate business. The only reason we sell hamburgers is because they are the greatest producer of revenue from which our tenants can pay us rent." Today, franchisees pay about 12% of the average units \$1.6 million sales in rent and another 4% in royalties. In addition, they also share marketing costs and buy some of their suppliers from headquarters (Forbes, 2001). Such strategy (forward integration), structure (different business model), and uniformity (reward systems, hierarchical management structure, routine in serving food) have made McDonald's the brand name that defined American fast food.

## MCDONALD'S: FALLEN ARCHES

Obviously, McDonald's is globalisation. But that is perhaps the point: globalization has not turned out to be all that simple an affair. In 2002, McDonald's posted its first loss as a result of the failure of the company's attempt to diversify. For the full year,

earnings were \$893.5 million, down 45 per cent from \$1.64 billion in 2001. Revenue rose 2 per cent to \$41.53 billion (2001-2002), although sales for restaurants open at least a year dipped 2.1 per cent (McDonald's financial report, 2002). It shows a remarkable turn down in sales after year 2000 (table 2). The sales in 2002 dropped to \$2.1 billion (\$1.3 billion less than year 2000). In particular, with an exception of France, sales at stores open at least a year declined in its five biggest markets, U.S., Germany, Britain and Japan (Trend Setters, 2003). Since 1987, McDonald's share of fast-food sales in the U.S. has slipped almost two percentage points, to 16.2%. The drop has come even as the company has increased its number of restaurants by 50%, far outpacing the industry's expansion rate.

**Table 2. McDonald's Revenue (dollars in millions)**

	2004	2003	2002	2001	2000
Total Revenue	\$19,065	17,140	15,406	14,870	14,243
Operating Income	3,541	2,832	2,113	2,697	3,330
Net Income	2,279	1,471	893	1,637	1,977

\* Source: McDonald's financial report 2004, <http://www.mcdonalds.com/>

In 2003, McDonald's had revealed that it planned to pull out of three countries and to subject franchisees in four other countries to an ownership restructuring. In addition, McDonald's aimed to close 175 underperforming outlets in ten other nations and "eliminate" between 400 and 600 staff from its payroll worldwide, including 200 to 250 jobs domestically. The company's shares fell 7.9 per cent to \$17.79 on the New York Stock Exchange after the announcement (News Scotsman, 2003).

**Table 3. Stock Performance of the World's Top Six Brands**

BRAND	2-YEAR TOTAL RETURN
Coca-Cola	71%
Eastman Kodak	-8
Gillette	101
McDonald's	3
Sony	49
Walt Disney	78
S&P 500 Average	63

\* Source: Interbrand, Bloomberg Financial Markets. Cited in Businessweek.com (1998)

Moreover, investors are not happy by any means with the company performance. As shown in table 3, over the past two years, while the Standard & Poor's 500-stock index grew by 63%, McDonald's shareholders could have made more money. Had you invested \$100 in the company two years ago, you'd be holding \$103 today. Of the world's 10 most powerful brands, as ranked by Interbrand, a New

York consultant, only Eastman Kodak Co. has had a worse run over that period. Shareholders of Gillette Co., meanwhile, have more than doubled their money.

What is more, McDonald's is confronting with even more fundamental problem: the quality of its food. While the company focused on building more stores, consumers have decided they want better food and more variety. Consumers who eat fast food at least once a month say that both Wendy's and Burger King offer better-tasting fare, according to a recent Business Week/Harris Poll (Table 4) and in a soon-to-be-released survey for Restaurants & Institutions magazine in which 2,800 consumers graded chains based on the taste of their food, McDonald's ranked 87<sup>th</sup> out of 91<sup>st</sup>. Likewise, according to the Harris Poll more than 90% of consumers listed both taste and quality as "very important" factors in their choice of a restaurant, while location and speed were selected by barely half. Convenience, therefore, is no longer enough. With an abundance of choices, consumers no longer choose McDonald's just because there is one around the corner. In addition, with new entrants offering ethnic fare, vegetarian menus, and fully stocked salad bars, fast food no longer has to mean fried food (Businessweek.com, 1998).

**Table 4. Consumer Survey**

The Best Tasting Food		The Best Tasting Burgers	
Wendy's	36%	Burger King	42%
Burger King	32%	Wendy's	32%
McDonald's	21%	McDonald's	17%
Other	8%	Other	7%
Don't know	2%	Don't know	2%

(Note: Results cover only those who say they eat fast food at least once a month.)

\* Source: Business Week, <http://www.businessweek.com/1998/10/b3568001.htm>

Consequently, Eric Schlosser, whose devastating book on the "all-American meal", *Fast Food Nation*, swept the world last year, compared McDonald's position with that of the British Empire just before the First World War. "If you looked at a map, half the world was colored pink. But there were all sorts of problems lurking beneath the surface," he claimed (News Scotsman, 2003).

## ANALYSIS AND DISCUSSION

### What went wrong: management, strategy or operation?

Apparently, McDonald's has to deal with several issues regarding the decline in performance. The writers analyze that first, in spite of the unfavorable market condition at the macro level for McDonald's such as the mad cow disease in Europe, global wave



of anti-US sentiment; the first issue comes from the inside: the company management approach. McDonald's has largely clung to the "McFamily" philosophy of the 1950s and 1960s, which rewards managers who start young and stay for life. Managers who had spent ten years at the firm were still regarded as new. Moreover, this long-serving headquarter staff were taking many operating decisions, for example on pricing, without reference to franchisees or to consumer research data (Financial Times, 1998). As a result, management team was very conservative to adapt with the market changes and on top of it, they were too confident about McDonald's capacities.

Second, the rapid expansion strategy was an appropriate corporate strategy level in the past however not anymore. Compare the McDonald's strategy with that at other companies that have prospered despite wrenching changes in their industries. When GE realized that manufacturing had become less profitable, it moved into financing. When Walt Disney Co. found it hard to attract more people to its theme parks, it built hotels and captured more dollars from the tourists already there. And Coca-Cola spun off its bottling business and focused instead on becoming a marketing powerhouse (Business Week, 1998). These companies (GE, Disneyland and Coca Cola) have applied the horizontal diversification strategy in which the companies develop new products that are dissimilar to their existing product line technologically but may possibly appeal to current customers (Hunger & Wheelen, 2003, p. 104; Kotler, 2003, p. 101). As described in term of Ansoff's product-market expansion grid, McDonald's should have developed diversification strategy rather than consolidating the market share in decline-growth of fast-food sector (Fleisher & Bensoussan, 2003, p.335; Kotler, 2003, pp. 100-101). This can be seen through the price war such as 39 cent cheese burger was aimed to maintain and gain more market share from its rivals.

Importantly, by applying the well-known analyzing tool of *Porter's Five Forces Model*, namely (1) threat of new entrants; (2) bargaining power of supplier; (3) threat of substitutes; (4) bargaining power of buyers and; (5) intensity of rivalry (Fleisher & Bensoussan, 2003, p.68; David, 2003, p. 121), McDonald's was pressed from many different directions. It goes without saying that the capital requirement of entry and legislation are low and uncomplicated and thus the threat of entry is considered low fast-food sector. There is a glut of outlets resulting in over-capacity and over-stored conditions in many of the country's prime trading areas. According to Lewison (1994), there are 3,700 new outlets being built each year in U.S. Noticeably, the power of suppliers was not a big issue for

McDonald's. The power of consumer, however, was a significant aspect to McDonald's. Consumers are becoming more concerned about the nutrition and health. Menu items high in fat, sodium, and cholesterol are inconsistent with the changing consumer behavior pattern. As said by Take Stephen J. Char, a 31-year-old government scientist in Denver. He has cut his trips to McDonald's in half over the past few years. "*A cheeseburger and fries will kill me for the day*," he says. He has found tastier options near his office for about the same price: a taco restaurant, a German deli, and even Haji Babba's--a food counter at a Texaco station that serves stuffed grape leaves (Business Week, 1998). As discussed in the earlier section (p.4), the threat of substitutes (convenience food) was one of the main reasons in slowing down the fast-food industry and McDonald's, the giant in fast food, was suffered from this threat painfully. Consequently, McDonald would end up with tougher competition in a global scale. "*Fast casual*" chains (More expensive and fresher than fast-food; casual dining that is not full service) such as Café de Coral (Hong Kong chain) and Subway (American chain) are planning to take away market share from McDonald's (Independent, 2003). It is important to mention that in 1995, McDonald's starting receiving complaints from franchisers that they were granting too many franchises and stealing business from current stores. McDonald's was granting so many franchises that they began competing against themselves! For the first time, McDonald's proceeded to conduct market impact studies before granting any further franchises.

The wrong directions and stresses had led the company to some difficulties at the operational level. Corporate overhead runs 91% higher than at Tricon Global Restaurants, which owns 30,000 Taco Bell, Pizza Hut and KFC stores. McDonald's spends an average of \$45,000 to operate a domestic restaurant; \$63,000 on average for an overseas unit. This can be explained by continuous use of consumer sales incentives (coupon, premiums, discounts, and special promotions) which results in higher cost. In addition, niche marketing through product (menu) item proliferation by all of the fast-food chains (SuperBar by Wendy's, Chicken International by Burger King) is making it difficult to be a limited-menu restaurant. The shortfall in human resource is another crucial point to the existing problem of McDonald's.

Currently, the company has improved the situation by cutting jobs, being more careful with the expansion strategy, re-structuring the management hierarchy, introducing the new line of products and services, allowing franchisees to launch extensive experiments in food and décor, launching "*I'm loving it*" marketing theme (McDonald's financial report, 2004, p.3). In short, as said by David Kolpak, Victory

Capital Management, whose firm holds 1.22 million McDonald's shares "Clearly, they should have done this sooner, but it is better late than never" (Onebusiness.com, 2003). The success of these changes has shown remarkable results (McDonald's financial report, 2004, p.1). The total revenues increases 11 per cent to \$ 17 billion (2002-2003) and \$19 billion (2003-2004) as the net income goes up to 39 percent to \$1.4 billion (2002-2003) and 35 percent to \$2.3 billion (2003-2004). Even more, the company has announced strong revenue and income growth at the first quarter of 2005 (Investor release, 2005). It appears that McDonald's has regained its golden arch after its 50<sup>th</sup> anniversary.

## CONCLUSION

McDonald's case is a clear example of how the company's strategies should be changed to cope with the business environments. Despite a strong brand name and long successful history, McDonald's was not able to realize the situation before it became too late.

Firstly, the company did not observe carefully the market changes. Unfortunately, it was a downsize of the market regarding the market saturation, demographic, life style and threat of substitutions. Secondly, as a result of not being able to deal with these changes, corporate level *strategy* was not adjusted accordingly which resulted in low profit and market share. Conservative *management* culture was another dilemma for the company. Finally yet importantly, wrong direction in corporate level would lead to even more difficulties at the *operational* stage.

Further research on international companies can direct to more insights into reasons of successes and failures. In the complex changing environments nowadays, there would be some value in more empirical studies to investigate whether the global franchises format is continue to success or should other types of format are applied. It is also interesting to examine the appropriate franchise format in different cultures, namely the East and West.

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