

## Case 2-1: McDonald's: Comeback in the U.S. Burger Market?\*

McDonald's, one of the world's most iconic brands and companies, faced a crossroad in its comeback path. When Steve Easterbrook was appointed CEO in 2015, the company had lost an astonishing 500,000 U.S. customers in the previous four years. In 2015, for the first time, McDonald's closed more restaurants than it opened. Same-store domestic sales fell 1.3 percent in 2016, and the number of customers visiting McDonald's fell 2.1 percent that year, the fourth straight year for a decline in customers. Reflecting this trend, many younger people had never dined at McDonald's. As indicated by its recent declines in revenue and profit (see Tables 1 and 2), McDonald's faced a variety of challenges. Prices in groceries fell at the same time that the minimum wage was increasing and increasing dramatically in some cities and states. Given that labor was the largest component

of cost for restaurant chains, the cost gap between dining out and eating in was at its largest since the 1980s. Efforts to add more products for health-conscious customers such as salads and oatmeal had failed to attract enough new customers to stem the decline. The all-day breakfast menu, introduced in 2015, was a hit, but by 2017, it was losing steam as an engine of growth. A particularly salient threat was the rise of fast, casual burger chains that focused on better-tasting burgers. Chains such as Five Guy's, The Habit Burger Grill, SmashBurger, and In-N-Out among others were expanding at a rapid rate. Such chains typically started as regional enterprises, but each was expanding geographically. Five Guys, particularly, had clearly broken out as a national competitor.

To combat the various threats it faced, McDonald's was implementing digital kiosks for ordering. The company

**Table 1** McDonald's Income Statement, 2013-16 (In Millions of USD except for per share items)

	2016	2015	2014	2013
Revenue	24,621.90	25,413.00	27,441.30	28,105.70
Total Revenue	24,621.90	25,413.00	27,441.30	28,105.70
Cost of Revenue, Total	14,417.20	15,623.80	16,985.60	17,203.00
Gross Profit	10,204.70	9,789.20	10,455.70	10,902.70
Selling/General/Admin. Expenses, Total	2,410.50	2,473.20	2,511.40	2,407.40
Research & Development	-	-	-	-
Unusual Expense (Income)	130.50	62.60	9.70	-169.00
Total Operating Expense	16,877.40	18,267.50	19,492.10	19,341.40
Operating Income	7,744.50	7,145.50	7,949.20	8,764.30
Other, Net	-21.70	-16.50	-6.70	-44.90
Income Before Tax	6,866.00	6,555.70	7,372.00	8,204.50
Income After Tax	4,686.50	4,529.30	4,757.80	5,585.90
Net Income Before Extra Items	4,686.50	4,529.30	4,757.80	5,585.90
Net Income	4,686.50	4,529.30	4,757.80	5,585.90
Preferred Dividends	-	-	-	-
Diluted Weighted Average Shares	861.20	944.60	986.30	1,006.00
Diluted EPS Excluding Extraordinary Items	5.44	4.79	4.82	5.55
Dividends per Share	3.61	3.44	3.28	3.12

\* This case was prepared by William Hesterly for the purposes of class discussion.

**Table 2** McDonald's Balance Sheet, 2013-16 (In Millions of USD except for per share items)

	2016	2015	2014	2013
Cash & Equivalents	1,223.40	7,685.50	2,077.90	2,798.70
Short Term Investments	144.40	4.50	137.90	16.00
Cash and Short Term Investments	1,367.80	7,690.00	2,215.80	2,814.70
Accounts Receivable - Trade, Net	1,474.10	1,298.70	1,214.40	1,319.80
Total Receivables, Net	1,474.10	1,298.70	1,214.40	1,319.80
Total Inventory	58.90	100.10	110.00	123.70
Prepaid Expenses	388.10	499.20	562.20	763.60
Other Current Assets, Total	1,559.70	55.00	83.10	28.30
Total Current Assets	4,848.60	9,643.00	4,185.50	5,050.10
Property/Plant/Equipment, Total - Gross	34,443.40	37,692.40	39,126.10	40,355.60
Accumulated Depreciation, Total	-13,185.80	-14,574.80	-14,568.60	-14,608.30
Goodwill, Net	2,336.50	2,516.30	2,735.30	2,872.70
Long Term Investments	725.90	792.70	1,004.50	1,209.10
Other Long Term Assets, Total	1,855.30	1,869.10	1,744.60	1,747.10
Total Assets	31,023.90	37,938.70	34,227.40	36,626.30
Accounts Payable	756.00	874.70	860.10	1,086.00
Accrued Expenses	1,402.90	1,583.90	1,382.90	1,432.80
Notes Payable/Short Term Debt	0.00	0.00	0.00	0.00
Current Port. of LT Debt/Capital Leases	77.20	-	-	-
Other Current Liabilities, Total	1,232.20	491.80	504.90	651.20
Total Current Liabilities	3,468.30	2,950.40	2,747.90	3,170.00
Long Term Debt	25,878.50	24,122.10	14,935.70	14,129.80
Total Long Term Debt	25,878.50	24,122.10	14,935.70	14,129.80
Total Debt	25,955.70	24,122.10	14,935.70	14,129.80
Deferred Income Tax	1,817.10	1,704.30	1,624.50	1,647.70
Other Liabilities, Total	2,064.30	2,074.00	2,065.90	1,669.10
Total Liabilities	33,228.20	30,850.80	21,374.00	20,616.60
Common Stock, Total	16.60	16.60	16.60	16.60
Additional Paid-In Capital	6,757.90	6,533.40	6,239.10	5,994.10
Retained Earnings (Accumulated Deficit)	46,222.70	44,594.50	43,294.50	41,751.20
Treasury Stock - Common	-52,108.60	-41,176.80	-35,177.10	-32,179.80
Other Equity, Total	-3,092.90	-2,879.80	-1,519.70	427.60
Total Equity	-2,204.30	7,087.90	12,853.40	16,009.70
Total Liabilities & Shareholders' Equity	31,023.90	37,938.70	34,227.40	36,626.30
Total Common Shares Outstanding	819.30	906.80	962.90	990.40

was also experimenting with home delivery and table service. Perhaps most importantly, McDonald's was considering changes in the way it prepared its burgers to improve taste. Such changes had the potential to significantly alter McDonald's strategic position with respect to cost and differentiation. With McDonald's stock price lagging behind both the S&P 500 and Dow Jones Industrial Average, the company needed to figure the right path to a more sustainable turnaround.

### McDonald's Model

McDonald's employed the franchise business model for the vast majority of its restaurants. The franchise model was credited with McDonald's sustained growth and global expansion. In many instances, McDonald's acquired and developed prime real estate locations that it then leased back to franchisees. Some observers argued that McDonald's restaurants often enjoyed locational advantages compared to other burger chains. McDonald's set a goal of going from 83% to 95% franchise ownership of its restaurants. This would follow several other chains in what some termed the asset-light business model. Burger King, Carl's Jr., Hardee's, Dunkin Donuts, and Subway were all either 100-percent or nearly - 100-percent franchised owned. The franchise model posed some challenges. Getting franchisees to upgrade locations, adopt new technologies, and change the standard McDonald's menu often took considerable time and effort. Such changes could take several months at a minimum and, in some cases, several years.

Though there was some regional variability such as the McLobster in Maine, McDonald's offered a high degree of standardization in its menu across the U.S. McDonald's offered a breakfast menu, which in 2015, was extended from only morning hours to an all-day offering. McDonald's was best known for its hamburgers, but offered other items including Chicken McNuggets and a variety of sandwiches. McDonald's had emphasized with some success a McCafé line of items such as coffee, latte, shakes and smoothies. From time to time, McDonald's had offered special items for a limited time and had incrementally changed its menu from time to time. Many observers argued that, because of McDonald's immense scale, menu changes often occurred slowly both in formulation and implementation. For example, it did not expect to complete its plan to switch to free range eggs until 2025.

Despite the extent of its franchising, McDonald's was renowned for the uniformity of experience and consistency in quality that it offered customers. McDonald's typically served food within minutes of a customer's order. It was not unusual for customers to receive their food within one

minute of ordering. While downtown McDonald's locations in the largest cities were an exception, most U.S. McDonald's locations offered drive-through service. Some estimates put the percentage of revenue from drive-through customers at 70 percent of revenue for the typical McDonald's. McDonald's had optimized its food production over several decades to deliver food of consistent quality with the short waits that customers expected. McDonald's supply chain could procure, process, and deliver frozen beef and potatoes to its stores with both high reliability and scale. This system helped McDonald's both reduce costs and ensure a high degree of consistency. McDonald's hamburgers were generally cooked and then warmed before delivery to a customer. This allowed McDonald's to serve customers much faster than waiting for orders before cooking the burgers.

### Trends in Hamburgers

The market for premium burgers made with fresh beef had increased dramatically in the previous decade and was expected to double over the next five years. As recently as 2001, Five Guys had consisted of five stores in the Washington D.C. area. By 2016, it had more than 1,400 locations (see Table 3). Though much smaller than Five Guys, Shake Shack was founded in 2004, and Smashburger in 2007, while The Habit Burger Grill expanded from 23 restaurants in 2007 to 145 by 2016. Even In-N-Out, a California-based chain that had traditionally eschewed growth and geographic expansion, had grown from 89 locations in California and Las Vegas in 1999 to over 300 locations in the western United States and Texas. All of

**Table 3** Number of U.S. Locations for McDonald's and Burger Competitors

Restaurant Chain	Number of Locations
McDonald's	14,259
Burger King	7,500
Wendy's	1,440
Carl's Jr./Hardee's	3,450
Jack in the Box	2,954
Five Guys	1,440
SmashBurger	315
Shake Shack	268
The Habit	145
In-N-Out	313

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**Table 4** McDonald's Versus Select Competitors on Time to Serve

	McDonald's	Five Guys	In N Out	Wendy's	Smashburger	Habit
Time from receiving receipt to hamburger	2:18	6:55	7:49	0:40	7:30	6:52
Drive-through available	Yes	No	Yes	Yes	No	No

**Source:** Data collected by casewriter's research assistant. The data above is based on one mid-afternoon visit to each of the chains and may not be indicative of overall averages. All of the hamburgers were served within the store rather than by way of drive-through service.

these chains featured menus with significantly fewer items than McDonald's and were, arguably, much more focused on burgers. All featured burgers made from fresh beef that were cooked upon order. This necessarily involved longer wait times (see Table 4). Most did not offer drive-through service. In-N-Out was the exception in that much of its business was drive-through and its hamburgers were not offered at a premium price (see Table 5). In addition to the several fast-growing chains that had emerged, there were many smaller chains that operated in various cities across the U.S. Multiple polls had shown consumers preferred the taste of burgers from chains such as Habit, Smashburger, In-N-Out, Five Guys, and Shake Shack among others to those of McDonald's. Many were limited to specific metropolitan areas while others had a larger geographic footprint. McDonald's also faced competition from its larger traditional competitors such as Burger King, Wendy's, Jack in the Box, as well as Carl's Jr. and its sister chain, Hardee's. Unlike the upstarts in the premium segment, the traditional competitors had not experienced significant growth in previous years. At one point after 2010, Burger King experienced same-store sales declines

for 11 consecutive quarters. The number of Wendy's locations had declined from approximately 6,500 to 5,722 in the U.S. since 2011.

### McDonald's Strategy

The growth in premium burgers made from fresh beef was not lost on McDonald's as consumer ratings showed the company lagging behind competitors on burger taste (see Tables 5 and 6). The company initially responded by experimenting with the removal of artificial preservatives and replacing margarine with butter among other similar changes. McDonald's then used Dallas as a test market for hamburgers made from fresh beef. The fresh-beef burgers were well-received by customers who rated them higher in taste than McDonald's traditional burgers. McDonald's announced in March 2017 that, by mid-2018, Quarter Pounders would be prepared with fresh beef in a majority of its restaurants. Quarter Pounders would also be cooked when ordered rather than cooked previously and stored in warmers.

**Table 5** McDonalds and Select Competitors Price Comparisons

Chain	Lowest Priced Burger	Median Priced Burger	Highest Priced Burger
McDonald's	\$.90	\$2.80	\$4.85
In-N-Out	2.25	2.55	3.65
The Habit Burger Grill	3.15	4.30	5.85
Five Guys	4.59	6.19	7.79
SmashBurger	5.39	6.69	7.69

**Source:** Casewriter comparisons in Salt Lake City, Utah, May 2017.

**Table 6** Consumer Reports Burger Ratings, 2014

Habit	8.1
SmashBurger	7.9
Culver's	7.7
Steak'n Shake	7.5
Wendy's	6.8
McDonald's	5.8

**Source:** "McDonald's Knows It's Losing the Burger Battle – Can it Come Back?" *Wall Street Journal*, Oct. 6, 2016 <https://www.wsj.com/articles/mcdonalds-knows-its-losing-the-burger-battlecan-it-come-back-1475769684>. Accessed May 28, 2017.

A shift to fresh beef was not without risks. Industry insiders suggested that employing fresh beef in burgers could extend the time between the order and the serving of a burger. Using fresh beef would likely increase the cost of burgers. Price sensitive customers might be less inclined to purchase McDonald's burgers. The use of fresh beef increased health risks as well. Fresh beef was much more susceptible to viruses than frozen beef. Chipotle's had still not fully recovered its customer base from problems with bacterial contamination more than two years earlier. A change to fresh beef would also dramatically change McDonald's supply chain and logistics for delivering beef to its stores.

McDonald's announced in March 2017 that it would roll out mobile ordering to all of its U.S. locations. Pizza chains had successfully used mobile ordering for years. In another action that followed long-standing practice by pizza chains, McDonald's also announced that it would dramatically accelerate and scale food delivery. The company had long experimented with delivery and already offered it in markets other than the U.S., particularly Asia and the Middle East. It was not clear how McDonald's planned to rapidly scale delivery, but there was considerable industry speculation that the company might enter an alliance with a delivery service firm such as GrubHub, Inc. McDonald's vast superiority in the number of its restaurants was seen as an advantage in delivery. Many more potential customers lived or worked close to a McDonald's compared to rivals in burgers and fast food generally. In addition to delivery and mobile ordering, the company also planned to spend approximately \$1 billion renovating its existing stores.

As part of McDonald's turnaround strategy, the company planned to emphasize the McCafe drinks. In February of 2017, the company announced that McCafe drinks would sell for \$2. More generally, McDonald's had placed a global emphasis on serving high quality coffee at a price considerably less than coffee houses.

Most of McDonald's strategic moves—such as the emphases on mobile ordering and store renovation—were seen as either low-risk or catch-up strategies. A shift to fresh beef would potentially have a more profound effect on the company. Would McDonald's traditional price-sensitive customers pay a premium for more costly burgers? Would they tolerate longer waits both in the restaurants and drive-throughs?

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