

CASE 3

MCDONALD'S IN 2017*

On January 18, 2017, McDonald's announced that it was introducing two new versions of the Big Mac on a limited basis. Although such changes are necessary for the world's largest restaurant chain, the new offerings will be similar to the original version because they will use frozen beef patties and a secret sauce. This is unlikely to address the shift in tastes among consumers for fresher beef and a variety of toppings. In fact, a recent survey indicated a serious cause for concern for the firm, finding that only 20 percent of Millennials had even tried a Big Mac (see Exhibits 1, 2, and 3).

Nevertheless, Steve Easterbrook, who took the helm of McDonald's in March 2015, has continued to push for changes to several of the ingredients that the firm has been using in its products. It has removed high fructose corn syrup from its buns, changed from the use of liquid

margarine to real butter, decided to use chicken that has been raised without antibiotics, and to make use of cage-free eggs. Mike Andres, president of McDonald's USA, explained why the firm has decided to make these changes: "Why take a position to defend them if consumers are saying they don't want them?"¹

These changes are expected to address some of challenges that McDonald's has been facing in many markets, including the U.S., where it has over 14,000 of its 35,000 mostly franchised restaurants. It has lost a lot of ground with consumers, especially Millennials, who are defecting to traditional competitors like Burger King and Wendy's as well as to new designer burger outlets such as Five Guys and Shake Shack. Changing tastes are also responsible for the loss of customers that are lining up at fast-casual chains such as Chipotle Mexican Grill and Panera Bread, which offer customized ordering and fresh ingredients (see Exhibit 4).

Over the years, McDonald's response to this growing competition was to expand its menu with snacks, salads and new drinks. From 33 basic items that the chain offered in 1990, the menu had grown by 2014 to 121 items. The greatly expanded menu led to a significant increase in

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	Year Ending		
	Dec. 31, 2016	Dec. 31, 2015	Dec. 31, 2014
Total Revenue	\$24,622	\$25,413	\$27,441
Operating Income	7,744	7,145	7,949
Net Income	4,686	4,529	4,758

Source: McDonald's.

EXHIBIT 1
Income Statement
(\$ millions)



	Year Ending		
	Dec. 31, 2016	Dec. 31, 2015	Dec. 31, 2014
Current Assets	\$ 4,849	\$ 9,643	\$ 4,186
Total Assets	31,024	37,939	34,281
Current Liabilities	3,468	2,950	2,748
Total Liabilities	33,228	30,851	21,428
Stockholder Equity	(2,204)	7,088	12,853

Source: McDonald's.

EXHIBIT 2
Balance Sheet
(\$ millions)



EXHIBIT 3

Breakdown of Revenues (\$ millions)



	2016	2015	2014
U.S.	\$8,253	\$8,559	\$8,651
International Lead Markets	7,223	7,615	8,544
High Growth Markets	6,161	6,173	6,845
Foundational Markets & Corporate	2,985	3,066	3,401

Source: McDonald's.

EXHIBIT 4

U.S. Market Share of Fast-Food Burger Chains

McDonald's	2016	17.0%
	2014	49.6%
	2012	50.0%
	2010	49.2%
Wendy's	2016	4.4%
	2014	12.3%
	2012	12.2%
	2010	12.7%
Burger King	2016	15.4%
	2014	11.9%
	2012	12.1%
	2010	13.2%
Five Guys	2016	1.8%
	2014	1.7%
	2012	1.5%
	2010	1.1%

Source: *USA Today*, December 8, 2014; and author estimates.

costs and longer preparation times. This forced the firm to increase the prices of many of its items and to take more time to serve customers, moving it away from the attributes that it had built its reputation upon. "McDonald's stands for value, consistency and convenience," said Darren Tristano, a restaurant industry consultant.²

The fast food chain has been through a similar crisis before. Back in 2002–2003, McDonald's had experienced a decline in performance because of quality problems as the result of rapid expansion. At that time, the firm had brought James R. Cantalupo back out of retirement to turn things around. He formulated a "Plan to Win," which has been the basis of McDonald's strategy over the last decade. The core of the plan was to increase sales at existing locations by improving the menu, refurbishing the outlets, and extending hours. This time, however, such incremental steps might not be enough.

Pulling out of a Downward Spiral

Since it was founded more than fifty years ago, McDonald's has been defining the fast food business. It provided millions of Americans their first jobs even as it changed their eating habits. It rose from a single outlet in a nondescript Chicago suburb to become one of the largest chains of outlets spread around the globe. But it gradually began to run into various problems which began to slow down its sales growth (see Exhibit 5).

This decline could be attributed in large part to a drop in McDonald's once-vaunted service and quality since its expansion in the 1990s, when headquarters stopped grading franchises for cleanliness, speed, and service. By the end of the decade, the chain ran into more problems because of the tighter labor market. McDonald's began to cut back on

EXHIBIT 5 McDonald's Milestones

- 1948 Brothers Richard and Maurice McDonald open the first restaurant in San Bernadino, California, that sells hamburgers, fries, and milkshakes.
- 1955 Ray A. Kroc, 52, opens his first McDonald's in Des Plaines, Illinois. Kroc, a distributor of milkshake mixers, figures he can sell a bundle of them if he franchises the McDonalds' business and install his mixers in the new stores.
- 1961 Six years later, Kroc buys out the McDonald brothers for \$2.7 million.
- 1963 Ronald McDonald makes his debut as corporate spokesperson using future NBC-TV weatherman Willard Scott. During the year, the company also sells its 1 billionth burger.
- 1965 McDonald's stock goes public at \$22.50 a share. It will split 12 times in the next 35 years.
- 1967 The first McDonald's restaurant outside the U.S. opens in Richmond, British Columbia. Today there are 31,108 McDonald's in 118 countries.
- 1968 The Big Mac, the first extension of McDonald's basic burger, makes its debut and is an immediate hit.
- 1972 McDonald's switches to the frozen variety for its successful French fries.
- 1974 Fred L. Turner succeeds Kroc as CEO. In the midst of a recession, the minimum wage rises to \$2 per hour, a big cost increase for McDonald's, which is built around a model of young, low-wage workers.
- 1975 The first drive-through window is opened in Sierra Vista, Arizona.
- 1979 McDonald's responds to the needs of working women by introducing Happy Meals. A burger, some fries, a soda, and a toy give working moms a break.
- 1987 Michael R. Quinlan becomes chief executive.
- 1991 Responding to the public's desire for healthier foods, McDonald's introduces the low-fat McLean Deluxe burger. It flops and is withdrawn from the market. Over the next few years, the chain will stumble several times trying to spruce up its menu.
- 1992 The company sells its 90 billionth burger, and stops counting.
- 1996 In order to attract more adult customers, the company launches its Arch Deluxe, a "grownup" burger with an idiosyncratic taste. Like the low-fat burger, it also falls flat.
- 1997 McDonald's launches Campaign 55, which cuts the cost of a Big Mac to \$0.55. It is a response to discounting by Burger King and Taco Bell. The move, which prefigures similar price wars in 2002, is widely considered a failure.
- 1998 Jack M. Greenberg becomes McDonald's fourth chief executive. A 16-year company veteran, he vows to spruce up the restaurants and their menu.
- 1999 For the first time, sales from international operations outstrip domestic revenues. In search of other concepts, the company acquires Aroma Cafe, Chipotle, Donatos, and, later, Boston Market.
- 2000 McDonald's sales in the U.S. peak at an average of \$1.6 million annually per restaurant. It is, however, still more than at any other fast-food chain.
- 2001 Subway surpasses McDonald's as the fast-food chain with the most U.S. outlets. At the end of the year it had 13,247 stores, 148 more than McDonald's.
- 2002 McDonald's posts its first-ever quarterly loss, of \$343.8 million. The stock drops to around \$13.50, down 40% from five years ago.
- 2003 James R. Cantalupo returns to McDonald's in January as CEO. He immediately pulls back from the company's 10–15% forecast for per-share earnings growth.
- 2004 Charles H. Bell takes over the firm after the sudden death of Cantalupo. He states he will continue with the strategies that have been developed by his predecessor.
- 2005 Jim Skinner takes over as CEO after Bell announces retirement for health reasons.
- 2006 McDonald's launches specialty beverages, including coffee-based drinks.
- 2008 McDonald's plans to add McCafes to each of its outlets.
- 2012 Don Thompson succeeds Skinner as CEO of the chain.
- 2015 Thompson resigns because of declining performance and is replaced by Steve Easterbrook, the firm's chief branding officer.
- 2016 McDonald's opens restaurant in the 120th country; the first McDonald's restaurant opens in Astana, Kazakhstan, on March 8, 2016.

Source: McDonald's.

training as it struggled hard to find new recruits, leading to a dramatic falloff in the skills of its employees. According to a 2002 survey by market researcher Global Growth Group, McDonald's came in third in average service time behind Wendy's and sandwich shop Chick-fil-A Inc.

By the beginning of 2003, consumer surveys were indicating that McDonald's was headed for serious trouble. Measures for the service and quality of the chain were continuing to fall, dropping far behind those of its rivals. In order to deal with its deteriorating performance, the firm decided to bring back retired Vice-Chairman James R. Cantalupo, 59, who had overseen McDonald's successful international expansion in the 1980s and 1990s. Cantalupo, who had retired only a year earlier, was perceived to be the only candidate with the necessary qualifications, despite shareholder sentiment for an outsider. The board had felt that it needed someone who knew the company well and could move quickly to turn things around.

Cantalupo realized that McDonald's often tended to miss the mark on delivering the critical aspects of consistent, fast, and friendly service and an all-around enjoyable experience for the whole family. He understood that its franchisees and employees alike needed to be inspired as well as retrained on their role in putting the smile back into the McDonald's experience. When Cantalupo and his team laid out their turnaround plan in 2003, they stressed getting the basics of service and quality right, in part by reinstating a tough "up or out" grading system that would kick out underperforming franchisees. "We have to rebuild the foundation. It's fruitless to add growth if the foundation is weak," said Cantalupo.³

In his effort to focus on the core business, Cantalupo sold off the non-burger chains that the firm had recently acquired. He also cut back on the opening of new outlets, focusing instead on generating more sales from existing outlets. Cantalupo pushed McDonald's to try to draw more customers through the introduction of new products. The chain had a positive response to its increased emphasis on healthier foods, led by a revamped line of fancier salads. The revamped menu was promoted through a new worldwide ad slogan, "I'm loving it," which was delivered by pop idol Justin Timberlake through a set of MTV style commercials.

Striving for a Healthier Image

When Jim Skinner took over from Cantalupo in 2004, he continued to push for McDonald's to change its image. Skinner felt that one of his top priorities was to deal with the growing concerns about the unhealthy image of McDonald's, given the rise of obesity in the U.S. These concerns were highlighted in the popular documentary *Super Size Me*, made by Morgan Spurlock. Spurlock vividly displayed the health risks that were posed by a steady diet of food from the fast food chain. With a rise in awareness of the high fat content of most of the products offered by McDonald's, the firm was also beginning to face lawsuits from some of its loyal customers.

In response to the growing health concerns, one of the first steps taken by McDonald's was to phase out supersizing by the end of 2004. The supersizing option allowed customers to get a larger order of French fries and a bigger soft drink by paying a little extra. McDonald's also announced that it intended to start providing nutrition information on the packaging of its products. The information will be easy to read and will tell customers about the calories, fat, protein, carbohydrates and sodium that are in each product. Finally, McDonald's has also begun to remove the artery-clogging trans fatty acids from the oil that it uses to make its French fries and has recently announced plans to reduce the sodium content in all of its products by 15 percent.

But Skinner was also trying to push out more offerings that are likely to be perceived by customers to be healthier. McDonald's has continued to build upon its chicken offerings using white meat with products such as Chicken Selects. It has also placed a great deal of emphasis upon its new salad offerings. McDonald's has carried out extensive experiments and tests with these, deciding to use higher quality ingredients, from a variety of lettuces and tasty cherry tomatoes to sharper cheeses and better cuts of meat. It offered a choice of Newman's Own dressings, a well-known higher-end brand. "Salads have changed the way people think of our brand," said Wade Thoma, vice president for menu development in the U.S. "It tells people that we are very serious about offering things people feel comfortable eating."⁴

McDonald's has also been trying to include more fruits and vegetables in its well-known and popular Happy Meals. It announced in 2011 that it would reduce the amount of French fries and phase out the caramel dipping sauce that accompanied the apple slices in these meals. The addition of fruits and vegetables has raised the firm's operating costs, because these are more expensive to ship and store because of their more perishable nature. "We are doing what we can," said Danya Proud, a spokesperson for the firm. "We have to evolve with the times."⁵

The rollout of new beverages, highlighted by new coffee-based drinks, represents the chain's biggest menu expansion in almost three decades. Under a plan to add a McCafe section to all of its nearly 14,000 U.S. outlets, McDonald's has been offering lattes, cappuccinos, ice-blended frappes and fruit-based smoothies to its customers. "In many cases, they're now coming for the beverage, whereas before they were coming for the meal," said Lee Renz, an executive who was responsible for the rollout.⁶

Refurbishing the Outlets

As part of its turnaround strategy, McDonald's has also been selling off the outlets that it owned. More than 80 percent of its outlets are now in the hands of franchisees and other affiliates. Skinner is working with the franchisees to address the look and feel of many of the chain's aging stores. Without any changes to their décor, the firm is likely to be left behind by other more savvy fast food and

drink retailers. The firm is in the midst of pushing harder to refurbish—or re-image—all of its outlets around the world. “People eat with their eyes first,” said Thompson. “If you have a restaurant that is appealing, contemporary, and relevant both from the street and interior, the food tastes better.”⁷

The re-imaging concept was first tried in France in 1996 by Dennis Hennequin, an executive in charge of the chain’s European operations, who felt that the effort was essential to revive the firm’s sagging sales. “We were hip 15 years ago, but I think we lost that,” he said.⁸ McDonald’s has been applying the re-imaging concept to its outlets around the world, with a budget of more than half its total annual capital expenditures. In the U.S., the changes cost as much as \$650,000 per restaurant, a cost that is shared with the franchisees when the outlet is not company owned.

One of the prototype interiors being tested out by McDonald’s has curved counters with surfaces painted in bright colors. In one corner, a touch-activated screen allows customers to punch in orders without queuing. The interiors can feature armchairs and sofas, modern lighting, large television screens and even wireless Internet access. The firm is also trying to develop new features for its drive-through customers, which account for 65 percent of all transactions in the U.S. They include music aimed at queuing vehicles and a wall of windows on the drive-through side of the restaurant allowing customers to see meals being prepared from their cars.

The chain has even been developing McCafes inside its outlets next to the usual fast food counter. The McCafe concept originated in Australia in 1993 and has been rolled out in many restaurants around the world. McDonald’s has been introducing the concept to the U.S. as part of the refurbishment of its outlets. In fact, part of the refurbishment has focused on the installation of a specialty beverage platform across all U.S. outlets. The cost of installing this equipment is running at about \$100,000 per outlet, with McDonald’s subsidizing part of this expense.

The firm has planned for all McCafes to offer espresso-based coffee, gourmet coffee blends, fresh baked muffins and high-end desserts. Customers will be able to consume these while they relax in soft leather chairs listening to jazz, big band, or blues music. Commenting on this significant expansion of offerings, Marty Brochstein, executive editor of *The Licensing Letter*, said: “McDonald’s wants to be seen as a lifestyle brand, not just a place to go to have a burger.”⁹

Rethinking the Business Model

In response to the decline in performance, McDonald’s is testing other new concepts, including a kiosk in some locations that allows customers to skip the counter and head to tabletlike kiosks where they can customize everything about their burger, from the type of bun to the variety of cheese to the many glossy toppings and sauces that can go on it. Dubbed the “Create Your Taste” platform, McDonald’s is hoping the kiosks will attract more younger customers

who may be moving away from frozen processed food that is loaded with preservatives. The firm has plans to gradually expand the concept to more locations, but there are risks involved with making such a change. Franchisees are concerned about the costs, which can run up to \$125,000 per restaurant to make the required changes. The burgers are priced higher at \$5.49, can take seven minutes to prepare, can only be ordered from inside the store, and eventually are brought to your table. Franchisees have complained the concept cannot be offered to drive-through customers that make up such a large portion of the chain’s business. “Customization is not McDonald’s historic strength,” said Mark Kalinowski, an analyst at Janney Montgomery Scott.¹⁰

Further, such a change runs counter to the image of inexpensive and fast food that McDonald’s has worked hard to build over the years. Easterbrook has acknowledged that its customized menu is a work in progress. He stated that the firm is also testing a downsized version that would allow both in-store and drive-through customers to choose a bun and one of four sandwich types. At the same time, McDonald’s is hoping that this will bring more customers inside their outlets, bringing the U.S. counter/drive-thru customer ratio closer to 50/50, up from the current 30/70.

McDonald’s has also been working to simplify its menu, reducing the number of “value meal” promotions, groups of items that together cost less than ordering items individually. It has tweaked its “dollar menu” replacing it with “dollar value and more,” raising the prices for many items as part of a bid to get each customer to spend more. But McDonald’s first introduced these bargain menus because its prices had risen over the years, driving away customers to cheaper outlets. Consequently, as much as 15 percent of the chain’s sales have been coming from its “dollar menu” where everything costs a dollar.

McDonald’s saw a slight jump in U.S. sales after launching an all-day breakfast at almost half of its locations. The franchisees had to be convinced to invest about \$5,000 to add food preparation space in order to offer breakfast along with the regular lunch or dinner items. However, sales from the all-day breakfast had begun to flatten out by the end of 2016, as no additional sales were coming from customers who were ordering breakfast.

More Gold in these Arches?

In spite of all the changes that have been made by Easterbrook, sales growth for McDonald’s has continued to be sluggish. The firm does, however, believe that sales will rebound in the U.S. as well as in foreign markets. In order to provide a boost to its operations in China and Hong Kong, McDonald’s announced a deal with Citic, a state-owned conglomerate, and the Carlyle Group, a private equity firm. They plan to open more outlets and to expand to many smaller cities that show potential for growth. “China and Hong Kong represent an enormous growth opportunity for McDonald’s,” Easterbrook said in a recent news release. “The new partnership will

combine one of the world's most powerful brands and our unparalleled quality standards with partners who have an unmatched understanding of the local markets."¹¹

McDonald's has also been trying to grow by reaching out to different customer segments with different products at different times of the day. It has tried to target young adults for breakfast with its gourmet coffee, egg sandwiches, and fat-free muffins. It attracts working adults for lunch, particularly those who are squeezed for time, with its burgers and fries. And its introduction of wraps has drawn in teenagers late in the evening after they have been partying.

Restaurant analyst Bryan Elliott commented: "They've tried to be all things to all people who walk in their door."¹² The current marketing campaign, anchored around the catchy phrase "I'm loving it," takes on different forms in order to target each of the groups that it is seeking. Larry Light, who was the head of global marketing at McDonald's and pushed for this new campaign, insists that the firm has to exploit its brand through pushing it in many different directions. In spite of these efforts, 30 percent of sales come from just five items: Big Macs, hamburgers, cheeseburgers, McNuggets, and fries.

The expansion of the menu beyond the staple of burgers and fries raises some fundamental questions. Most significantly, it is not clear just how far McDonald's can stretch its brand while keeping all of its outlets under the traditional symbol of its golden arches. In fact, industry experts believe

that the long-term success of the firm may well depend on its ability to compete with rival burger chains. "The burger category has great strength," says David C. Novak, chairman and CEO of Yum! Brands, parent of KFC and Taco Bell. "That's America's food. People love hamburgers."¹³

ENDNOTES

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3. Pallavi Gogoi and Michael Arndt. Hamburger hell. *BusinessWeek*, March 3, 2003, p. 105.
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6. Janet Adamy. McDonald's coffee strategy is tough sell. *Wall Street Journal*, October 27, 2008, p. B3.
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12. *Fortune*, December 1, 2014, p. 110.
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