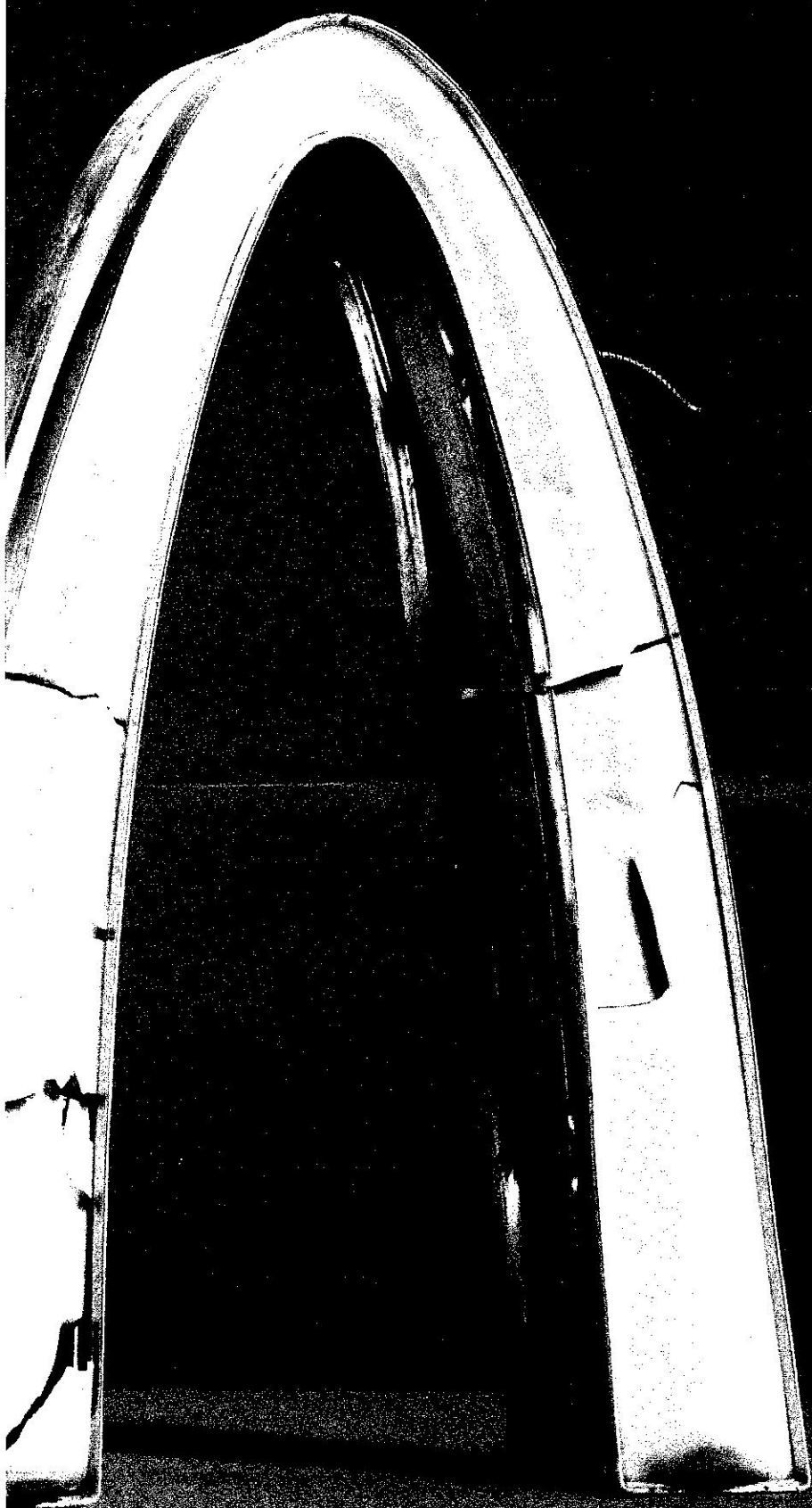


FALLEN ARCHES

THE WORLD'S
LARGEST
RESTAURANT
COMPANY
IS LOSING
MARKET
SHARE,
LOSING SALES,
AND
SUFFERING
ONE HECK
OF A
CORPORATE
IDENTITY
CRISIS. CAN
MCDONALD'S
EMBATTLED
CEO GET THE
COMPANY'S
MOJO BACK?

By **BETH
KOWITT**



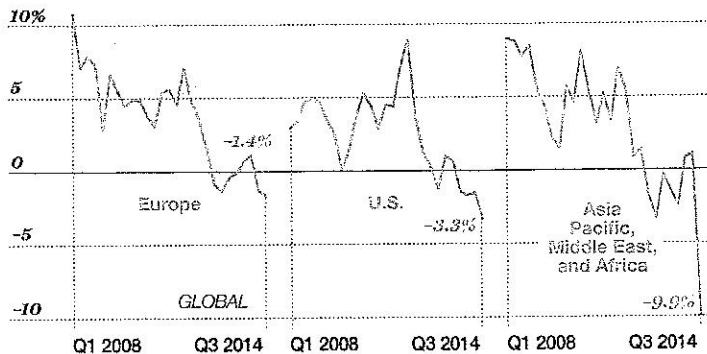
PERHAPS NO EPISODE captures what's ailing the world's largest restaurant company better than the Mighty Wings Debacle of 2013. In September of last year, McDonald's launched an ambitious program to sell deep-fried chicken wings across its 14,000 U.S. locations. The wings were a staple in Hong Kong, where the crisp cayenne-and-chili-pepper coating was developed. And a similar version tickled palates in Atlanta during testing. One blogger wrote: "Holy crap, those are really freakin' good." The wings were giant ("bone in," as the jargon went) and meaty. And by the end of the heavily advertised eight-week promotion, McDonald's was left with 10 million pounds of unsold chicken, a whopping 20% of its inventory. The Mighty Wings didn't flap. ¶ At corporate headquarters in Oak Brook, Ill., executives began pointing fingers. Some blamed the coating, which was too spicy for broad American tastes, they said. Some blamed the price, at a hefty \$1 per wing. A box of five Mightys cost a

LOSING ITS LEAD?

McDonald's still lures in far more customers than the competition, but the chain's restaurant sales are slipping fast. Under Don Thompson's watch, same-store sales have fallen across all major regions.

SAME-STORE SALES

Quarterly, over same period the previous year



RESTAURANT CHAINS' U.S. MARKET SHARE, 2013

McDonald's	7.3%
Subway	2.6
Starbucks	2.2
Wendy's	1.8
Burger King	1.7
Taco Bell	1.5
Dunkin' Donuts	1.4
Pizza Hut	1.2
Chick-fil-A	1.0
Applebee's	0.9

buck more than the equivalent number at KFC. McDonald's had justified the lofty price because the wings were so immense, taken from its suppliers' gigantic eight-pound chickens. The wings were arguably a bona fide deal. But this brings up problem No. 3: Customers didn't make that connection. Cost-conscious diners gazing up at the menu didn't realize they'd be getting "absurdly huge drumettes," as the blogger put it. "This was quality for price," a former executive tells *Fortune*, "but McDonald's is known for quantity for price." McDonald's might have thought they were value. Customers simply viewed them as expensive.

CEO Don Thompson, then in the job for a little over a year, had

needed the wings to be a hit. The company's performance had slipped on his watch, suffering from disappointing sales growth and deteriorating margins. Since then things have gotten worse—much worse. In late October, McDonald's reported a significant loss of market share and its fourth straight quarter of negative same-store sales in its U.S. operations. Overall, the company reported a distressing 30% decline in profit. Expenses were growing even as sales were falling—a big problem for any company.

Analysts are now predicting that 2014 will be the first year of negative global same-store sales since 2002. "People have seen results go from the best in the industry to one of the worst in the course of three years," says Stephens analyst Will Slabaugh. The year has been written off—there will be no bonuses for anybody.

Some of the pressures facing the company are beyond its control: higher commodity costs, fiercer competition, a restaurant industry showing little to no growth, and a strapped lower-income consumer. There have also been a handful of one-off disasters, including a supplier in China accused of selling expired meat and the closure of nine company-owned restaurants by the government in Russia. (See "Cold War on Business: The Putin Paradox" on *Fortune.com*.) With its \$28.1 billion in revenue—the average McDonald's restaurant brings in \$2.6 million in sales, compared to Burger King's \$1.2 million, according to research firm Technomic—the company's scale makes it harder to move the needle. McDonald's

McDonald's numbers are heading south under CEO and president Don Thompson.



size makes it a target too, putting it in the cross hairs of minimum wage and nutrition battles.

But the company has even bigger—dare we say, Mighty Wing-size—challenges, not least of which is an existential one: McDonald's is the quintessential quick-serve restaurant. It has risen to the top of the fast-food chain by being comfortably, familiarly, iconically “mass market” and so ubiquitous as to be the Platonic ideal of “convenient.” Neither of these selling points, however, is as high as it was even a decade ago on Americans’ list of dining priorities. A growing segment of restaurant goers are choosing “fresh and healthy” over “fast and convenient,” and McDonald's is having trouble convincing consumers that it's both. Or even can be both. “It is a battle over perception, and they're losing,” says Aaron Allen, a global restaurant consultant.

Meanwhile, it's clear that other chains are winning: In the third quarter of 2014, while McDonald's same-store sales were falling about 3%, those at Chipotle Mexican Grill, the big cheese of the burrito world, were soaring 20%. (See our “Businessperson of the Year” package, beginning on page 139.)

Thompson may not have that much time to change those dynamics. Many insiders—*Fortune* spoke with 19 current and former McDonald's

executives, as well as more than two dozen industry analysts and veterans—are starting to question if Thompson is up to the task and how long his tenure will last. So far he has tried shaking up his own executive team, replacing two presidents of the U.S. business in two years, eliminating the chief operating officer role, and reorganizing the U.S. business to make it “a flatter, more nimble organization,” says the company. But critics are wondering if the fix should come higher up the org chart. “Anytime operations aren't going as planned,” says Sanford C. Bernstein analyst Sara Senatore, “at some point the buck does stop with the CEO.”

Or the board of directors. “We're very supportive of Don,” says nonexecutive chairman Andrew McKenna. “We see the leadership team moving forward with a sense of urgency, which is good.”

On his most recent earnings call Thompson talked of a new customizable burger platform for McDonald's, a more regional approach to the menu, and investments in digital initiatives. There was also a nod to the fact that McDonald's has been slow in responding to more secular shifts. “In some of our markets the reality is that we haven't been changing at the same rate as customers' eating-out expectations—or more specifically, their expectations of us at McDonald's,” he said on the call. A week later, in an interview with *Fortune* at his Oak Brook office, Thompson goes a step further: “What we have to do is look at the gap in terms of what we want to be and aspire to be vs. how we're viewed,” he says.

When those things fall out of line, you get Mighty Wings.



RAY PERKINS, the coach who followed the legendary “Bear” Bryant at the University of Alabama, lasted four seasons before the grumbling Tide faithful helped drive him back to the NFL. David Gregory never quite emerged from the shadow of the mighty Tim Russert at *Meet the Press*. In his eight years as CEO of McDonald’s, Jim Skinner had eight years of consecutive positive same-store sales growth, a nearly 50% increase in revenue, and a more than doubling in profits. In 2011 the company took the title of top-performing stock in the Dow for the one- and five-year periods. The next year Don Thompson got the job.

His ascension was a proud moment for McDonald’s. A company veteran of nearly 25 years, Thompson was suddenly one of six black CEOs in the *Fortune* 500—and only the 14th in history. Skinner is a no-nonsense guy, a 5-foot-6 Iowan who never graduated from college. Thompson, an NFL-size 51-year-old with a degree in electrical engineering from Purdue, is a hugger. (Note: Sources will alert you to this fact if you’re planning to meet the man.) And he has the sort of rags-to-riches story that makes you want to root for him. Born in Chicago’s Near North Side, he was raised by his grandmother, who moved the family to Indianapolis to escape the neighborhood’s growing gang violence. After graduating from Purdue, Thompson spent six years at defense contractor Northrop before getting a call from a headhunter about a job at McDonald’s. It seemed so far afield that he thought the recruiter meant the aerospace company McDonnell Douglas. In 2007 he told *Black Enterprise* magazine that when he discovered the position was with the fast-food chain, he said, “You got the wrong guy, because I’m not flipping hamburgers for anybody.” He was concerned about what his grandmother would think. He ended up taking the job, which entailed designing robotics for things like food transport and cooking equipment, then moved into operations, and eventually became Skinner’s trusted No. 2.

But almost from the minute he landed in the corner office, the arc

At a McDonald’s restaurant in Oak Brook, Ill. Thompson began his nearly 25-year career at the company as an engineer.

of his career trajectory began to flatten. In his first earnings call as CEO, Thompson had the awkward responsibility to report a slowdown in sales growth in most of the company’s major markets, with both he and CFO Peter Bensen pointing to the impact of a tough macroeconomic environment. By the end of 2012 analysts began asking why the company was performing worse than it had during the peak of the financial crisis, when consumer confidence was even lower.

There was no shortage of answers. For starters, there were certain operational failures, some of which—like menu creep—had been decades in the making. In 1990 *Fortune* covered the proliferation of McDonald’s menu, noting that the restaurant offered 33 items, not counting size permutations. That was up 25% from 1980. Today the menu has 121 items, a 75% increase from 2004, according to industry consultant Allen. Overall, McDonald’s brings in about \$20,000 in sales per offering, per restaurant, on average. Compare that with high-end burger joint Shake Shack. Each of its 44 menu items average about \$66,000 in sales per store—more than three times the average for McDonald’s, Allen says.

Menu management can be compared with organizing a closet. When one new item comes in, another must go out or chaos ensues. “The menu has gotten unwieldy,” says Bryan Elliott, a restaurant analyst at Raymond James. “They’ve tried to be all things to all people who walk in their door.” In truth, McDonald’s customers tend to want the same things: Thirty percent of sales come from just five items—Big Macs, hamburgers, cheeseburgers, McNuggets, and fries.

So why add to the mix? It generates news—and in the case of the cult classic McRib, even a little bit of frenzy. The company is quick to point out that even Mighty Wings “had strong ethnic appeal and generated positive customer excitement.” The drawback is that both a new menu and a big menu slow down operations. Between March and July of 2013, McDonald’s rolled out McWraps, Egg White Delights, blueberry pomegranate smoothies, and three additional twists on the company’s venerable Quarter Pounder. That year McDonald’s had its slowest average time in the history of *QSR Magazine*’s “Drive-Thru Perfor-

DANIEL AGER—McDONALD’S VIA GETTY IMAGES



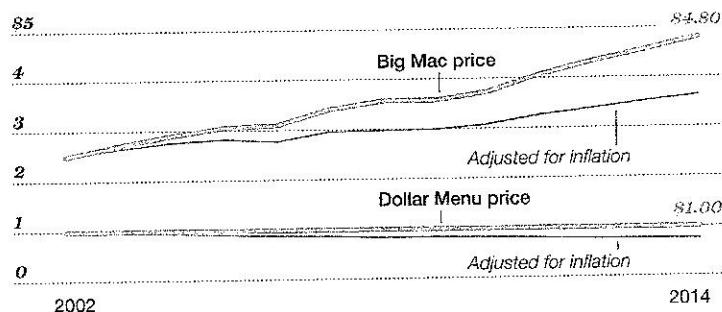
mance Study," with 189.49 seconds. (Executives at Oak Brook have since conducted an "operations reset" and brought what they call high-density prep tables into the kitchen to help with speed and customization.)

Thompson, who is known for having strong opinions about the menu pipeline, has been a big advocate of exporting products from one market to another, à la Mighty Wings, to generate menu "excitement." Take the McWrap, which originated in Poland and then was imported to the U.S. According to an internal company memo, unearthed by *Advertising Age*, the chain believed this was the "perfect food offering to address the needs of [a] very important customer to McDonald's"—millennials—and brought the McWrap, along with a marketing blitz, back to the States. Management apparently thought so highly of the sandwich it called it the "Subway buster," a reference to one of McDonald's biggest competitors, the privately held Subway chain, which has an even greater number of outlets (nearly 43,000) than the Golden Arches (approaching 36,000).

To take advantage of the cost efficiencies that come with global

BIG MAC STICKER SHOCK

McDonald's Dollar Menu has long been a draw for diners. But as premium and higher-margin menu items get relatively more expensive, it's harder for customers to "trade up."



Former CEO Jim Skinner retired in 2012 after an eight-year run in which the company wowed investors.

scale, Thompson directed that the McWrap recipe and ingredients remain the same as they were in Europe. Company insiders say they are not selling well—though whether that's due to varying American tastes or other factors is an open question. (McDonald's declined to comment specifically on McWrap sales, but said the item "provides flexibility." On a previous earnings call it said the product met expectations.)

Pricing has been another problem. The McDonald's business model is to incrementally grow average check and guest counts. Each year the company raises its menu prices to cover increasing food costs, but it generally keeps those price hikes below the rate of inflation for "food away from home" to stay competitive. McDonald's also competes with grocery stores, where the rate of food inflation is typically lower, limiting how much gold the Golden Arches can charge.

That price dynamic is remarkably sensitive—probably more than many economists would guess. When the company nudged up prices above food-away-from-home inflation in the first quarter of 2014 (a rare move for McDonald's), the average check grew, but the number of customers dropped.

To get around this constraint, McDonald's employs a barbell strategy for pricing—Dollar Menu items on one end of the spectrum and premium items (the McWrap, Mighty Wings) on the other. The hope is that customers will be drawn into the restaurant by the Dollar Menu and then tempted to buy a product with better margins. That kind of trading up was easier for customers in 2002, when the Dollar Menu launched and a Big Mac cost \$2.49. But over time the weights on the barbell have moved further and further apart (see chart). Today the average Big Mac in America costs \$4.80, which many believe is too much of a jump. "The price-quality value is way out of whack," says a former executive, adding that the company needs more items in the middle of the menu that can act as a steppingstone.

As the premium products creep closer to the pricing of restaurants like Panera Bread and Chipotle—a relatively new class of eatery labeled "fast casual"—and even approach designer burger joints like Shake Shack and Five Guys, McDonald's risks losing customers.

The other option is to adjust the weight on the

TIM KLEIN—CONTOUR BY GETTY IMAGES; GRAPHIC SOURCE: THE ECONOMIST'S BIG MAC INDEX; BUREAU OF LABOR STATISTICS

low side. About 15% of the company's sales came from its traditional Dollar Menu—where for years everything cost a buck. To improve margins there, the chain in 2012 carved out a new roster (called Extra Value Menu), where some food—guess what?—cost more than a buck. No surprise, it flew as well as the Mighty Wings. “We had Extra Value Meals, plus we had Dollar Menu, [which was] rather confusing not only to customers but actually kind of confusing to us,” said Tim Fenton, then McDonald's chief operating officer, on a January earnings call. It's not clear, however, that the company learned its lesson: After eliminating the Extra Value Menu last year, it launched the Dollar Menu & More, which is another hodgepodge of offerings McDonald's (at least) considers good deals.

The pricing conundrum may be the fast-food industry's most difficult equation—and Thompson, an engineer who talks in terms of equations, has clearly thought deeply about this one. “When we talk about value, value is experience divided by price,” he says. “That's the equation we use. When you focus only on price, the challenge is that you cheapen the brand.” But McDonald's value equation works only when both the customer and the company score experience the same way. That doesn't seem to be the case.

There is, indeed, another equation at work here: McDonald's food = ?

THIS PAST SUMMER, a survey in *Consumer Reports* showed that McDonald's customers ranked its burgers significantly below those of 20 competitors. It also had the lowest rank in food quality of all rated hamburger chains in the *Nation's Restaurant News* 2014 Consumer Picks survey. Worse, McDonald's ratings among diners put the chain at No. 104—on a list of 105 restaurants without table service. (Only Chuck E. Cheese's scored lower.) “It's hard to say the quality is significantly worse than everybody else in the category. I just don't believe that,” says Dennis Lombardi of WD Partners, which conducted the survey. “It's factually unsupportable, but since perception is reality, it's an issue.” These kinds of ratings don't happen in a vacuum. Inherent in the score is the way eating McDonald's food and associating with the brand makes customers feel.

“McDonald's food is genuinely good,” a former executive tells *Fortune*. “There are no games when you feed 70 million people a day. But McDonald's needs to tell that story to people who don't blindly accept it.”

That's particularly important when it comes to the fast-growing demographic of health-conscious eaters. McDonald's classic offerings may have less fat and calories than some of its leading competitors, but consumers still aren't buying that the restaurant is “healthier.” Consider Chipotle, a chain in which McDonald's was an early investor (it sold its stake in 2006). Chipotle's burritos actually have more calories than a Big Mac, but the company's fare is seen as being natural, unprocessed, and sustainable—qualities that matter more to today's consumers than “low fat” and “low calorie,” according to a recent survey by Technomic. That's particularly true for two key demographics McDonald's absolutely needs to woo: families with

NOT LOVIN' IT

McD's latest marketing foray is a flop before it ever begins—at least in the Twittersverse.

WHEN WORD LEAKED out that McDonald's had trademarked the phrase (and, well, equation), “Lovin' > Hatin'”, the reaction on social media was swift and harsh. Though the fast-food chain insisted that the new wording was never intended to replace the company's longstanding catchphrase, “I'm lovin' it,” the *Wall Street Journal* reported it would debut on New Year's Day and even get an airing in the Super Bowl—claims the company dismissed as “highly speculative and premature.” Still, the masses erupted with derision. “Lovin' > Hatin'—Nietzsche,” tweeted Chris Remo to his 36,000 followers. “McDonalds changes their slogan to ‘Lovin' > Hatin' in an attempt to be hip, yet still forces its employees to wear visors,” quipped Canadian radio host Tyler Middleton. Branding experts merely shook their head. “I think the phrase created a certain amount of confusion,” says Tim Calkins, a marketing professor at Northwestern's Kellogg School of Management. “It's not certain what McDonald's is trying to communicate.” And ambiguity is not a good thing for McDonald's, as evidenced by a tweet from *espnW* columnist and on-camera host Sarah Spain: While lovin' may indeed be greater than hatin', “Hatin' Beats Heart Disease.” For now, it doesn't look as if this mathematical theorem will make it into the pantheon of McDonald's slogans, alongside the “Two all-beef patties” jingle and “You Deserve a Break Today.” Once a phrase gets tainted, says Calkins, “it can spoil the water before you even roll it out.”

kids under 12—Technomic found that this group's share in the McDonald's visitor pool declined to 14.6% in 2014, from 18.6% in 2012—and the aforementioned millennials.

Thompson has talked a lot about engaging younger customers through mobile and other technology, but if you don't give them something that more closely aligns with what they want to order, it doesn't matter if they're buying it on their iPhone or iPad or using Apple Pay. Again, look at Chipotle, which has the lowest-tech method for ordering: pointing with your finger.

FOR GENERATIONS, Ronald McDonald faced off against a freckled girl with pigtails and a manic-looking king. It never had to compete with the likes of Danny Meyer, the founding force behind fabled New York restaurants like Union Square Café, Gramercy Tavern, and Eleven Madison Park—Zagat royalty all. But Meyer's sparkling Shake Shack chain, founded in 2004 and set to go public perhaps as early as this year, has entered the burger wars. So have niche players like Five Guys, Smash-burger, Umami Burger, Elevation, and an ever-fattening roster of competitors in a new category called “better burger.” (The name says a mouthful.)

For a company that measures its output in “bil-

lions served," this may not seem like real competition. But the twin ascendance of the better burger and fast casual chains are being felt in Oak Brook, you can be sure. The fast casual segment (besides Chipotle and Panera, think Potbelly Sandwich Shop and Noodles & Co.) already accounts for more than \$30 billion in annual sales, and industry consultant Allen predicts it will hit \$100 billion in less than a decade. Experts disagree on whether McDonald's is losing meaningful share to the new breed or if it ever had that customer to begin with, but either way, says Allen, "a wedge is being driven into the industry." Having this point of comparison with the new chains, he says, has shone a glaring light on fast food's failings.

Thompson is not oblivious to any of these challenges. Earlier this year, on an earnings call, he was particularly forthcoming, telling investors that McDonald's had "lost some of our customer relevance." In truth, say numerous insiders and industry sources, that erosion had begun during the previous CEO's watch. Though Skinner had cleaned up and modernized restaurants and layered in new revenue drivers like McCafé beverages and extended hours, the company failed to address the fact that the McDonald's customer was evolving, says Larry Light, a consultant who was the company's global chief marketing officer until 2005. "The momentum was there," he says, "but momentum can cover up a lot of errors." Skinner declined to comment.

The management team is now feverishly working to fix some of those mistakes—simplifying the menu, giving more autonomy to regional heads to make their own product choices, and has brought in Boston Consulting Group to examine its pricing strategy. And insiders say the company has commissioned two consulting groups to look for \$100 million in savings that McDonald's can then put toward digital initiatives and a program the company is grandly calling "Experience of the Future."

That future, as Thompson envisions it, may include the opportunity for restaurant goers to build their own burgers, choosing from 22 toppings that they select on an in-store iPad or kiosk. (Sorry, bacon costs extra.) The program is now being tested in four California restaurants, but the CEO plans to have it rolled out to at least three U.S. markets by the third quarter of 2015. (It's being launched in Australia as of this writing.) The burgers aren't cheap: \$5.49—and they can only be ordered from inside the store, not the drive-thru. Indeed, that's part of the strategy. Thompson hopes it will drive more people into the restaurant, bringing the U.S. counter/drive-thru customer ratio closer to fifty-fifty, up from the current 30 to 70. The ultimate aim is to get more sales per square foot.

Dressing up a burger with toppings, of course, won't necessarily convince customers that the patty itself is any better. But it's not clear that Thompson thinks the burger needs improvement. (In the CEO's 60-minute interview with *Fortune*, he never talked about improving the quality of the chain's food.) "A lot of people enjoy and appreciate a McDonald's experience," he says, "and they understand by the number of times they've been there they've had real food and fresh food."

People who don't get that, it would seem, just haven't gotten the

message—at least to hear the current management tell it. "The informal eating-out industry, most specifically the quick-service industry, is under a much higher level of scrutiny today than I've seen at my time in McDonald's," says Thompson. "People today are questioning the integrity and the quality of the food at a much higher level, and there are a lot of accusations that frankly are unfounded relative to McDonald's. I know our supply chain. The food that we serve at McDonald's—they're the name brands that many people buy in grocery stores, but most people don't know that."

To get that point across, McDonald's spent roughly \$1 billion in U.S. advertising alone last year, according to Kantar Media. But here, too, there have been apparent missteps. When "Lovin' > Hatin'" emerged as possible new ad tag line for the company, it elicited scathing reaction in the Twitterverse (see box). "The problem is not the message. The problem is the product," says Neil Morgan, a marketing professor at Indiana University's Kelley School of Business. "The younger demographic is not going to a healthier fast casual restaurant because of the tag line."

"Lovin' > Hatin'" follows a campaign called "Our Food. Your Questions," adapted from a Canadian marketing effort. Here, the chain got former *MythBusters* star Grant Imahara to answer customer questions like "Is McDonald's beef real?" and "What are McRib patties made of?" In one YouTube video, Imahara takes viewers inside a McDonald's meat plant where we see beef going through the grinder and eventually getting packaged into boxes after it's flash frozen. "You need to hear about our food from us because you're hearing about it from so many other sources," Thompson tells *Fortune*. "We want to engage in a very truthful, very uncloaked dialogue about 'This is who we are. This is what our food is.'" The transparency is admirable, but showing off the inside of a meat factory may not be the best way to lure new customers. "The problem is the truth," says a former executive. "They are a mass feeder."

"McDonald's has forgotten over the past decade that the consumer makes emotional decisions," says Light, the former McDonald's CMO. He says that when consumers choose you based on convenience and price, you're just a commodity. "McDonald's confuses frequency with loyalty," he says. "You could be a frequent traveler of an airline you hate."

Hmm. Maybe there's more to McDonald's "Lovin' > Hatin'" equation than we thought. **F**