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MCDONALD'S AND THE MCCAFÉ COFFEE INITIATIVE

Ralph Sgro, on his usual morning tour of the Burlington-area McDonald's restaurants, stopped at a traffic light and counted the number of cars ordering through the Tim Hortons drive-through. The number of cars in his competitor's drive-through had been continually increasing over the last few years. Sgro was concerned that, although McDonald's breakfast sales were increasing, the breakfast market share had declined. As well, the snack business segment of McDonald's sales had not kept pace with industry growth. Sgro attributed the loss of market share predominantly to the growth of strong coffee competitors (including Tim Hortons) and McDonald's poor reputation for coffee. In response, Sgro introduced the McCafé concept to Canada, in May 2001, at restaurants in Burlington, Ontario.

McCafé was a full-service coffee bar located either as an extension of a McDonald's front counter or as a stand-alone restaurant. It had also been introduced in Australia, New Zealand, Brazil and many European countries. While McCafé was well received in Burlington, Sgro wondered if the McCafé concept would help McDonald's regain dominance in breakfast and snack-time sales and rebuild McDonald's competitive advantage.

THE CANADIAN FOODSERVICE INDUSTRY

The Canadian foodservice industry, which includes those businesses that transport, cook and serve prepared foods, grossed $32.7 billion and accounted for 4.3 per cent of Canada's gross domestic product (GDP).[1] Restaurant sales dominated this industry, accounting for 66 per cent of the foodservice industry, and of all the meals services, quick service (commonly known as fast food) accounted for about 60 per cent (see Exhibits 1 and 2). In 2001, Canadians spent $0.41 of every designated food dollar on meals prepared outside the home.[2]

Commercial restaurant growth had been attributed largely to an increase in franchising activity.[3] In the last 10 years, independently owned restaurants decreased by nearly 10 per cent. In the quick service industry, restaurants such as McDonald's, Wendy's and Burger King, competed with similar product lines, prices, speed of service and convenience. Industry players often fought for high traffic locations — it was not unusual to see a busy corner with two or three fast food restaurants clustered together.

Mergers, acquisitions and alliances were commonplace in this industry. In 1995, Wendy's International acquired Tim Hortons (TDL Group Ltd.) for $542 million. After acquiring some smaller American coffee chains, the Second Cup sold 37 per cent of their shares to Cara Foods (the owner of Harvey's and Swiss Chalet). The Second Cup entered into a distribution contract with The Great Canadian Bagel. In spite of this consolidation of the industry and the co-operative agreements, McDonald's continued to be the Canadian quick-service industry market share leader, second only to the Four Seasons Hotels and Resorts.

Quick-service consumers were both time and value conscious. They demanded low prices, good quality, safe food and fast service. Although Canadian consumption decisions were impacted by brand image and marketing, value and convenience were high on the priority list. While each competitor attempted to provide a unique offering, it was difficult to build customer loyalty, given the large number of restaurant choices.

THE RETAIL COFFEE INDUSTRY IN CANADA

Tim Hortons, McDonald's, Second Cup, Country Style, Coffee Time, Starbucks, as well as many independent coffee retailers, drove the coffee industry. Tim Hortons had the largest share of coffee consumption in Canada at 33 per cent. In Ontario, Tim Hortons lead with a 41.4 per cent market share, followed by

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[1] *Kostuch Information Services, Canada Multi-Unit Report of 125 Foodservice Operators, International Foodservice Manufacturers Association, Edition Canada, 1997.*
[2] *Kimberley Noble, "Fast Food Whole in One," Maclean's, August 20, 2001.*
[3] *Kostuch Information Services, Canada Multi-Unit Report of 125 Foodservice Operators, International Foodservice Manufacturers Association, Edition Canada, 1997.*

independent coffee chains at 22.1 per cent, McDonald's at 7.1 per cent, Second Cup at 4.4 per cent and Starbucks at one per cent. While many competitors focused on brewed coffee, specialty teas and specialty coffees, many were expanding their product lines to offer sandwiches, soups and other gourmet treats. Canadian consumers appeared to receive this product line extension well, as reflected by the 39 per cent increase in Tim Hortons lunch sales in 2000.

Each coffee competitor had a different value proposition. Reliability, quality and service all positively impacted the retailer's brand image. Further, some coffee houses catered to the coffee connoisseur, while others were simply convenient locations to consume good quality coffee. Producing consistent quality and taste in specialty coffee, however, required skill and training. Service was slower for specialty coffee retailers because the specialty coffee production process took approximately three to four minutes, compared to simply pouring a cup of brewed coffee. Specialty coffee customers seemed to accept long queues, long service times, varying quality and high prices.

Although coffee competitors distributed their products primarily through their individual retail outlets, many experimented with unique distribution strategies. For example, the drive-through had traditionally served brewed coffee, but many specialty coffee retailers had started to also offer drive-through service. Also, distribution alliances had formed in the coffee industry. Starbucks had joined with Chapters, and Second Cup with the Home Depot. Tim Hortons had partnered with Wendy's in 1995. Together, they opened Wendy's/Tim Hortons food court styled restaurants where a customer could order both Wendy's and Tim Hortons products at the same location.

The Canadian retail coffee industry had experienced explosive growth over the last five years. Annual retail coffee consumption had increased by 15 per cent to more than 16 million cups of coffee purchased every week in Canada. Although most Canadians still consumed their coffee in traditional sit-down retail coffee outlets, 29 per cent of the industry's coffee consumed was purchased from drive-throughs. Drive-through coffee consumption had grown almost fourfold since 1995.

Canadians, who consumed on average two or more cups of coffee per day, expected a different experience at different times of the day. Their morning consumption was driven by a "get up and go" ritual that required a convenient, dependable coffee source. In the afternoon, consumers wanted a coffee break — a "pick me up" or reward for their hard work. At night, coffee consumption was often a way to finish the evening meal. While specialty coffee growth had been significant, brewed coffee continued to be the dominant purchase throughout the day.

MCDONALD'S CORPORATION

Ray Kroc, the founder of the McDonald's system, opened the first McDonald's Restaurant in Des Plaines, Illinois, in 1955. Although McDonald's was originally a hamburger restaurant, McDonald's now offered a diverse menu and quick service in 121 countries worldwide. While each country offered a slightly different dining experience to cater to the local culture, food preparation and marketing were standardized across the globe — from Tokyo to Toronto, the Big Mac was the same. According to Tom Peters, the three most recognized brands in the world were McDonald's golden arches, Coca Cola and Disney.[4] In fact, these three brands often jointly marketed their products, further securing the primacy of their brands.

In the 1980s McDonald's experienced rapid growth, partly attributable to the successful "Big Mac Attack" ad promotion. By 2000, the McDonald's brand represented value and fast service. Through product innovation, McDonald's attracted many customer segments including families, teens and adults. After partnering with Disney, McDonald's Happy Meals revolutionized children's dining. With Ronald McDonald as the spokesperson, no other competitor was able to match the brand equity associated with the McDonald's Happy Meal. Furthermore, the introduction of the "combo meal" made McDonald's another favorite at both lunch and dinner for a variety of adult customers. In 2000, McDonald's in the United States and Canada initiated the "Value Campaign." This promotion slashed the prices of McDonald's small and large sandwiches, to bring "value" to the customer. McDonald's also built its reputation through community activities. Ronald McDonald Children's Charities (RMCC), for example, was established to help fund children's charitable causes.

McDonald's Corporation was a publicly held company based in Chicago, Illinois. The head office established standard marketing, operations and quality practices, but the international subsidiaries could make independent decisions that addressed the needs of their particular customers. International subsidiaries were accountable to the head office for profitability and had to regularly remit their financial statements and strategic positions to the international headquarters.

McDonald's Corporation adopted a growth by acquisition strategy. To leverage the strong McDonald's brand, it acquired Aroma Café, Boston Market, Chipotle Mexican Grill, Donatos Pizza and Pret A Manger. In 2000, McDonald's Corporation was the quick service industry leader with sales of $14.7 billion and the industry's highest profit margin of 12.4 per cent.

[4] *www.worklifechoices.org/brandyou.htm, referenced January 12, 2001.*

COMPETITION

The discussion below identifies the primary competitors to McDonald's.

Wendy's

Wendy's International, Inc. opened its first restaurant in 1969 and operated, developed and franchised a system of distinctive quick-service restaurants. Wendy's was known for its founder, Dave Thomas, and its unique menu blend of burgers, fries and healthy alternatives. Wendy's flagship products included the introduction of the salad in 1979, the baked potato in 1983 and the Super Value Menu in 1989. Furthermore, the introduction of the late night drive-through window allowed Wendy's customers to "eat great, even late." As of December 31, 2000, there were 5,792 Wendy's restaurants in the United States, Canada and 25 other countries and territories. Of these restaurants, 1,153 were operated by the company and 4,639 by the company's franchisees. The merger with the Canadian coffee and doughnuts icon, Tim Hortons, provided Wendy's the opportunity to expand into the coffee business in the United States, even though Tim Hortons continued to operate as a separate entity. Although Tim Hortons was best known for its coffee and doughnuts, the introduction of deli-style sandwiches, bagels and Tim's Own soups and chili made it a major player in lunch sales. As of December 31, 2000, there were 1,980 Tim Hortons restaurants in Canada and the United States, of which 95 per cent were owned by franchisees.

In 2001, Wendy's International Inc. enjoyed significant financial success. Its revenues increased by seven per cent as a result of strong domestic and international sales and its net income increased nine per cent largely attributed to improved operating performance at the Tim Hortons restaurants. More recently, Wendy's International focused much of its expansion through "combo units" of Wendy's and Tim Hortons in a food court-style.

Burger King

Burger King's reputation was associated with inexpensive food served quickly, in an attractive, clean environment. Founded in 1954, in Miami, Florida, there were more than 11,370 Burger King restaurants in 58 countries and international territories worldwide by 2002. The restaurants were owned and operated by independent franchisees. Burger King was best known for its flagship flame-broiled Whopper, its "Have it Your Way" motto (that enabled customers to design their own hamburgers) and its drive-through and take-out services (that accounted for 50 per cent and 15 per cent, respectively of their sales). In fiscal year 2002, Burger King, part of Diageo (an international food and drinks corporation), had system-wide sales of $11.4 billion.

KFC, Pizza Hut and Taco Bell

Tricon Global Restaurants, through its three brands, KFC, Pizza Hut and Taco Bell, developed, operated, franchised and licensed a worldwide system of restaurants which prepared, packaged and sold a menu of competitively priced food items. The Tricon organization operated more than 30,400 units in more than 100 countries and territories, and was the global leader in the chicken, pizza and Mexican restaurant categories. Tricon was also the leader in multi-branded quick-service restaurants with more than 1,100 locations worldwide. Multi-branding had proven to be a growth vehicle for Tricon in the United States, as consumers appeared to enjoy the variety of two or three dining options at the same location. In 2001, in spite of a three per cent drop in revenues as a result of foreign currency exchange issues and refranchising, net income rose 15 per cent due to restrained corporate and project spending.

MCDONALD'S CANADA

McDonald's Canada had approximately 1,200 locations throughout the country with 70 per cent owned and operated by franchisees. McDonald's Canada developed its own strategy, marketing plan and product line, although it was often similar to that of McDonald's USA. Canada based its success on the "three-legged stool": the company, the suppliers and the franchisees. Each leg brought stability to the partnership. Supplier "partners" included Coca Cola, Disney, Nestlé, Cuddy Foods, Mother Parkers, and Cossette Communications-Marketing.

McDonald's entered the Canadian breakfast industry in April 1976, and for many years, dominated the industry with its flagship Egg McMuffin sandwich and other hand-held product features. Tim Hortons was essentially ignored by McDonald's and was allowed free reign to develop its brand, based on the slogan of "Always Fresh" coffee and doughnuts. Even though the McDonald's breakfast business had grown, Sgro believed that McDonald's Canada did not allocate the necessary operational expertise and marketing drive to develop its coffee equity or breakfast business.

CORPORATE/FRANCHISEE RELATIONSHIP

Franchisees played important roles in the McDonald's system because of their customer contact and their entrepreneurial spirit. Although some franchisees were employees of McDonald's who were promoted through the corporate ladder, most franchisees applied from outside of the system because they saw the tremendous business opportunity. Franchisees were screened and selected for their entrepreneurial drive and prior business success. Franchisees were expected to act as owner-operators, not strictly as investors. They were required to be active in the day-to-day operations of their franchise and assume the responsibility of building the McDonald's system within the community. Franchisees paid a monthly rent and service fee to McDonald's Canada, based on a percentage of top-line sales. In addition, franchisees were required to meet the corporate standards of quality, service and cleanliness. They were obliged to contribute to the marketing fund and take an active involvement in all marketing initiatives. It was the franchisees' responsibility to represent the company well in their community, and to grow the business to the best of their ability. In return, franchisees leveraged McDonald's brand equity and received considerable support for every facet of their business. McDonald's Canada offered support in training, human resources, operations, marketing, construction, purchasing and product development. Through involvement in most of the functional areas of the business, the franchisees played active roles in the strategic direction of McDonald's Canada. Finally, McDonald's corporation and the franchisee shared in the cost of each restaurant. McDonald's owned the land (or the head lease) and the building, while the franchisee owned the equipment and décor package. A strong corporate/franchisee relationship was the cornerstone of the McDonald's philosophy.

OPERATIONS AND TRAINING

In Canada, all operations and training requirements were set and standardized by McDonald's Canada and were followed precisely in the restaurants. Each store was equipped with an operations and training manual that dictated everything from cooking times and temperatures, to drive-through service standards, and appearance standards. All products were prepared on the spot, offering "Made for You" service. Using clamshell grills, timed fryers and high-tech holding cabinets, McDonald's restaurants could produce quality products quickly. In recent years, drive-through service had been a priority throughout Canada, with numerous management initiatives focused both on the speed and accuracy of service. The overarching goal was to ensure that customers received the same food and service in Vancouver, B.C., as they did in Tokyo, Japan.

All salaried managers received standardized business training from the McDonald's Institute of Hamburgerology, which was based in Chicago and had affiliate campuses in Vancouver, Montreal and Toronto. McDonald's functioned as a meritocracy. Managers were evaluated through annual performance and compensation reviews based on standardized goals set by McDonald's Canada, goals set by the market franchisee and their ability to attain objectives that they set themselves to enhance personal development. Managers were offered competitive salaries and there existed considerable opportunity for advancement. They received regular feedback through Management Visitation Reports that graded the overall efficiency of their shift. They also received a performance review every six months and a formal wage review once a year.

Outside of the management team, McDonald's restaurants were staffed by part-time employees. These part-time workers were often teenagers looking to build their work experience or adults looking for a flexible job. Management tried to create an environment built on mutual respect, hard work and fun. Managers often organized monthly crew social outings, treat days and crew operational competitions. In addition, McDonald's offered all employees flexible scheduling, regular wage reviews, free uniforms and benefits. All McDonald's crew members were also given a McGold Card that allowed employees McDonald's food at half price, as well as a variety of discounts at local and national retail restaurants. To support their business, all McDonalds' crew received an orientation class, at least three training shifts, and were evaluated bi-monthly through a Station Observation Checklist that dictated precisely how to operate their particular station. Crew received a wage review every six months, which evaluated their Station Observation Checklist grades, as well as their versatility, initiative and leadership ability.

BURLINGTON OPERATIONS

Ralph Sgro, the owner-operator of the Burlington market, had more than 30 years of McDonald's experience. He began his career in 1973 as a front line manager in London, Ontario, and advanced through the system to become the senior field service manager of Eastern Canada in 1985. Within the corporate system, Sgro worked in a variety of operational areas, product development and menu management. In 1988, Sgro and his wife purchased the four-store market in Burlington, Ontario. In 2002, the Burlington market was home to seven restaurants. Although Sgro focused on Burlington, he continued to be involved with strategic planning for McDonald's Canada as the Ontario representative on the Partnering Committee. Sgro was recognized throughout the McDonald's for his operational involvement and commitment to the McDonald's system.

MCCAFÉ

On a recent vacation to Italy, the Sgros encountered McCafé, a full-service coffee bar located inside a downtown Rome McDonald's. McCafé offered espressos, cappuccinos and lattes, as well as cookies and pastries, complete with a marble countertop. Sgro believed that this European concept could be successful in Canada and could address the issue of Tim Hortons' increasing market share. Looking into the McCafé concept, Sgro discovered that there were more than 300 McCafés in 19 countries worldwide, including the United States.

After discussing the McCafé opportunity with his friend, the McDonald's Canada chief operating officer (COO), Bill Johnson, Sgro was given the go-ahead to introduce it to Canada. The implementation team, led by Sgro, comprised entrepreneurial and experienced corporate employees with diverse backgrounds in operations, marketing and menu management, as well as representatives from Cossette Advertising. The McCafé operational prototype was scheduled to open as an extension of the front counter at the Millcroft location in Burlington, Ontario.

In Canada, McCafé was positioned for working adults who enjoy coffee. McCafé was among the few restaurants that offered specialty coffee conveniently, quickly and relatively inexpensively. Its products included a full selection of specialty coffees and teas, 100 per cent Arabica-brewed coffee, baked goods and tins of the McCafé blend. All products could be purchased at both the front counter and through the drive-through. The McCafé design had a mahogany wood backdrop, stainless steel appliances and dark green accents. The baked goods were presented in a rounded, refrigerated, glass display case. The overall McCafé package was modern, sophisticated.

MCCAFÉ BURLINGTON

On May 26, 2001, McCafé Burlington opened its doors. The McCafé prototype restaurant was designed as an addition to the front counter at the Millcroft location in Burlington, Ontario. The purpose of this location was purely operational — an opportunity to work out the operational kinks before taking McCafé public.

Compared to the space requirements of other McDonald's equipment, McCafé equipment was relatively small, inexpensive and easy to fit into an existing counter. McCafé construction took less than four days, and did not significantly disrupt the McDonald's operations during construction. As with other McDonald's operations, McCafés were also standardized. Specialty coffee machinery poured lattes, cappuccinos and espressos at the push of a button, in 22 seconds. The McCafé equipment did not require the expertise of well trained baristas. The brewed coffee was prepackaged to ensure every pot of coffee had the same strength. Other than the cookies and muffins, none of the baked goods was prepared on site. The cakes were delivered in bulk packaging and cut as needed.

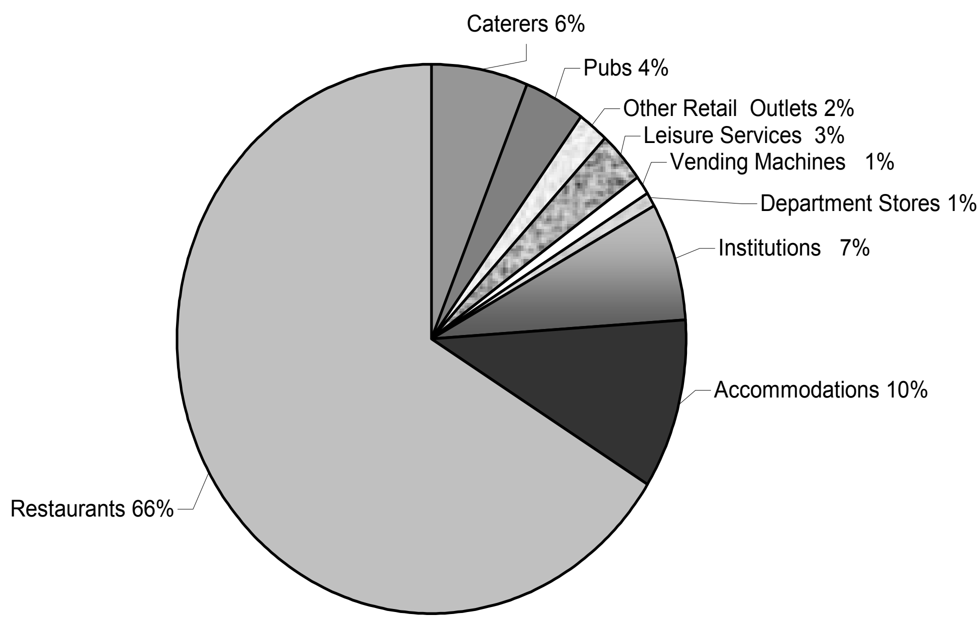
Local billboards and newspapers were used to advertise the new Burlington McCafé and in-store samples and promotions allowed customers to sample the new products. Comment cards were distributed to collect customer feedback on the new venture.

THE FUTURE OF MCCAFÉ IN CANADA

Sgro and his team were excited about McCafé. They were very pleased with the initial customer response and McCafé's ability to fit seamlessly into McDonald's operations. However, there was still much to learn about the product lines that were successful and those that were not. Further, the competition had not responded yet to McCafé. While breakfast sales had improved with McCafé, it was not clear whether the increase in sales would be sustained. While Sgro was optimistic about the future of McCafé , he was unsure if McCafé was the white knight needed to stem the loss of McDonald's market share in breakfast sales over the long term.

Exhibit 1

WHO GETS THE FOODSERVICE DOLLAR?



Source: Canadian Restaurant and Foodservices Association (CRFA) and Statistics Canada.

Exhibit 2

BEST PRODUCT PROSPECTS - CANADA

Share of Meal Occasions as a Percentage of Total Services
Commercial Foodservice Industry
1996 to 1998