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McDonald's looks back at customers

STUMBLING: With the US saturated by restaurants, CEO Jack Greenberg is pushing overseas. But critics say he has done so at the expense of food quality

BLOOMBERG, OAK BROOK, ILLINOIS
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McDonald Corp's Tokyo-based unit aims to triple its number of burger outlets by 2010, using an initial share offering this summer to help fund the move. This is a McDonald's in Tokyo's Shibuya.
PHOTO: BLOOMBERG

In the beginning, investors loved McDonald's Corp's new CEO, Jack Greenberg. During his first 15 months as chief executive, shares of the biggest US hamburger chain jumped 72 percent to a record US$48.38 in November 1999 from US$28.16 in September 1998.

Shareholders were optimistic about the former finance chief's plan to save US$100 million a year by cutting jobs and consolidating offices.

They gobbled up his Made for You initiative, which was designed to improve food quality by offering fresh rather than precooked burgers.

Greenberg's honeymoon is over. In the past year, he's battled consumer phobia about mad cow and hoof-and-mouth diseases in Europe and declines in the value of the euro, the British pound and the yen.

Vegetarian Hindus have sued over beef flavoring in fries. The company trailed rivals such as Burger King in a fourth-quarter poll of customer satisfaction.

Franchisees are griping that Greenberg's growth push is costing them profits.

On Sept. 7, the US Attorney's Office in Jacksonville, Florida, announced the indictments of 21 people for conspiring to defraud McDonald's promotions -- such as Who Wants to Be a Millionaire -- of more than US$20 million in prizes.

Those indicted included Jerome Jacobson, director of security at Simon Marketing Inc, the company running customer games for McDonald's. The Attorney's Office alleges that the scheme dated back to the late 1980s.

A McDonald's employee checks hamburger and other sandwich supplies in Assisi, Italy.
PHOTO: BLOOMBERG

In the most recent blow, the health department in Santiago shut down a McDonald's last week after a preliminary test disclosed the presence of e. coli bacteria in chicken.

"Every quarter, there's always something," says Trent Webster, portfolio manager of the Florida State Board of Administration in Tallahassee, which owns about 5 million McDonald's shares as part of its US$100 billion in assets for Florida public employees' retirement funds. "It seems like a repetitive problem. It makes me nervous."

`They complain about rude or slow service, dirty restaurants and sold-out Happy Meals (children's meals that usually feature a burger, fries, a drink and a toy). Worse, almost 70 percent of the complainers are dissatisfied with management's response. More than half of these disgruntled diners reduce future trips to the Golden Arches.'

McDonald's shares have given back the gains amassed during Greenberg's tenure. The stock closed at US$27.62 Thursday, down 19 percent this year. Shares of rival Wendy's International Inc, the third-largest US burger chain, closed at US$26.39, about the same as where they began the year.

A difficult year

Greenberg acknowledges that his company has stumbled.

"Clearly, 2001 has been a difficult year," he said in a teleconference from the company's Oak Brook, Illinois, headquarters.

On Sept. 19, Greenberg announced that sales in Europe had risen in August after declining during the first half of the year. In a press release, he said third-quarter earnings would be US$0.41 to US$0.42 a share, topping the US$0.39 forecast in a Thomson Financial/First Call analyst poll and about even with the US$0.41 profit a year earlier.

Cutting expenses

Greenberg said he plans to cut expenses in the fourth quarter. Analyst Damon Brundage at Raymond James & Associates Inc says McDonald's may trim jobs, reduce US franchisees to fewer than 2,000 from 2,800 and merge its five US divisions into three.

"McDonald's realizes, if it wants a shot at making its numbers in 2002, it has to take some specific steps in adjusting the cost structure," says Brundage, who rates the shares a "buy."

McDonald's spokeswoman Anna Rozenich wouldn't comment on specific actions. The company declined to make executives available for interviews.

One simple reason for Greenberg's woes: Diners prefer the fare at rival chains, while he has to draw customers by giving away toys such as Teenie Beanie Babies.

"They have lost their hold in the marketplace," says Mitzi Carletti, portfolio manager at Badgley Phelps & Bell Inc in Seattle, who sold her 30,000 McDonald's shares in the first quarter. "They've become much more of a toy store than a food store."

McDonald's -- with 43 percent of the market, according to researcher Technomic Inc -- had the lowest score in a customer satisfaction survey. In a University of Michigan Business School poll in the fourth quarter of 2000, the company received 59 points out of 100 compared with 70 for Wendy's and 67 for Burger King. That was worse than its 61-point score in the fourth quarter of 1999, when the company also lagged peers.

Rozenich says the fact that McDonald's served more than 8 billion customers in the US last year shows that diners are satisfied with the quality.

Rapid expansion

Critics say Greenberg lost his way by trying to expand too rapidly overseas at the expense of food quality and customer service at home. As a result, the US market -- which generated 37 percent of the company's US$14.24 billion in revenue last year -- has stagnated.

Without a boost from the US, McDonald's profit has declined for three consecutive quarters. In the most recent period, net income fell 16 percent to US$440.9 million, or US$0.34 a share.

With the US saturated by 12,804 McDonald's restaurants as well as competing chains, Greenberg is pushing overseas.

From 1998 to 2000, he increased the number of restaurants in Europe by 1,039 to 5,460, raised the Asia/Pacific presence by 1,205 outlets to 6,260 and upped Latin American stores by 410 to 1,510.

The expansion has been too aggressive, analysts say. "They're not a 10 to 15 percent grower anymore. Management needs to acknowledge this fact," says Raymond James's Brundage.

"They need to scale back international unit growth." Now the company is revamping its strategy again -- to pay more attention to its cuisine. "We have made a strategic shift to focus much more on food," Americas Division President Alan Feldman told analysts in a June 15 conference call.

In January, Greenberg introduced a New Tastes Menu, with 40 new offerings on a rotating basis. Included are a hot ham and cheese sandwich, the Eggs Benedict McMuffin and a US$0.99 barbecue chicken sandwich.

To expand beyond hamburgers, the company is branching into pizza, sandwiches, fancy desserts and premium coffees.

Following the lead of predecessor Michael Quinlan, who bought Denver-based Chipotle Mexican Grill in 1998, Greenberg purchased Columbus, Ohio-based Donatos Pizza Inc for an undisclosed price in 1999. Last year, he bought the Boston Market restaurant chain from bankrupt Boston Chicken Inc for US$176.2 million. Boston Market serves homestyle dinners such as chicken and mashed potatoes.

In January 2001, Greenberg added a 33 percent stake in Pret A Manger, an upscale UK-based sandwich outfit, for an undisclosed sum. He's also introduced a few coffee shops called McCafes in the Chicago area and in Australia. McCafes, located next to McDonald's shops, have comfortable couches and serve cappuccino and desserts like chocolate raspberry rumble cake.

While the new brands are promising, they're minuscule in the McDonald's world, generating US$564 million or about 4 percent of revenue last year.

Opportunity

"There's an opportunity for some growth in Donatos. Boston Markets will probably turn the corner, and there may be an opportunity for international growth," says Hilliard Lyons Inc restaurant analyst Tony Howard, who has a "hold" on McDonald's stock. "They are still very small relatively for the whole company."

New food initiatives have failed in the past. McDonald's unveiled the Arch Deluxe in 1996 in an effort to entice adults with a beefier, though more expensive, burger on a potato bun.

Not enough customers bought it. In markets such as Arkansas, franchisees dropped the price from as much as US$1.99 to US$0.99 -- the same price as many of its discount meals.

Made for You is facing setbacks too. Greenberg's idea was to prepare a meal only after it's ordered. In that way, a customer would get fresher, hotter food. Before Made for You was created, McDonald's outlets kept burgers in a heated bin after they'd been cooked, covered uniformly with condiments and wrapped.

With the new system, customers can tell the order taker to hold the onions or add more pickles. The burgers don't hang around in storage bins.

One drawback has been longer lines, especially at peak times. "They ran into quality problems and efficiency problems," says Tim Drake, senior equity analyst at Banc One Investment Advisors, which holds 3.9 million McDonald's shares after selling 234,000 in the spring of 2001.

Customers at rival Wendy's say the quality at McDonald's hasn't improved either.

"Wendy's has better sandwiches, the way they're seasoned.

They're more inventive," says Kathleen DeLillo, 47, area manager at Waterford Wedgwood Plc, who was dining at a Wendy's at 57th Street and Third Avenue in Manhattan.

Revamping

The revamping of food preparation has added to costs, requiring McDonald's to take a US$162 million charge in 1998 as it updated its kitchens. The charge contributed to a reduction in annual net income -- to US$1.55 billion in 1998 from US$1.64 billion in 1997.

Made for You has made mild inroads. "It did improve the absolute level of quality from a food perspective," says J. P. Morgan Securities Inc analyst John Ivankoe, who rates McDonald's a "long-term buy."

"But it has to be viewed as a defensive measure. Competitors were exceeding them so much in food quality, McDonald's had to do something." The high number of restaurant openings has also hurt service. During the past decade, McDonald's more than doubled its outlets to 29,000 from 12,000.

According to an internal McDonald's document entitled What We Know About Our Customers' Satisfaction With McDonald's, 11 percent of US customers are dissatisfied with their visit.

They complain about rude or slow service, dirty restaurants and sold-out Happy Meals (children's meals that usually feature a burger, fries, a drink and a toy). The document was posted on an in-house company Web site in July.

Worse, almost 70 percent of the complainers are dissatisfied with management's response. More than half of these disgruntled diners reduce future trips to the Golden Arches.

The economic cost, according to the document, is about 14,750 lost visits per year, or US$60,000 per restaurant -- an annual opportunity loss of about US$750 million in the US.

One of the least happy customers is Vincent Ingram, an 11-year-old Detroit native who allegedly ate a McDonald's cheeseburger full of maggots, according to his attorney, Arnold Reed. Reed is representing Ingram in a US$1 million lawsuit against the company, filed this year in Wayne County Circuit Court in Michigan on July 2.

Reed says Vincent, his mother and his sister Earlene purchased a burger at a Detroit McDonald's at 18403 Grand River Avenue.

"His sister notices white stuff coming out of his mouth. He wipes his mouth and sees it crawling around and freaks out. He throws up," Reed says.

Rozenich ,McDonald's spokeswoman says, "We believe this is a questionable claim against our restaurant." Another person, Noora Mohamad, filed a claim against a Toronto McDonald's in March, alleging that her daughter bit into a Big Mac and discovered a rat's head. Her attorney, Theodore Charney, senior partner at Falconer Charney Macklin in Toronto, says he's going to court on Friday.

Spokeswoman Rozenich says McDonald's Restaurants of Canada Ltd believe the allegations are false and are defending themselves against the claim.

On Sept. 27, Chilean health officials closed a McDonald's in the downtown mall in Santiago after finding e. coli in a Chicken McNugget.

Between Sept. 10 and Sept. 21, the health department tested 94 samples from 64 restaurants owned by six different fast-food chains. The department found the potentially deadly bacteria in one sample from McDonald's.

Complaints

In a written statement, spokeswoman Rozenich said McDonald's is cooperating with the Santiago department of health and conducting its own tests at independent laboratories.

"We'd caution anyone from jumping to conclusions based on only a preliminary review. There are no conclusive findings and we stand on our long track record of food safety," Rozenich said.

To address complaints, Greenberg has rolled out a Customer Recovery plan, according to the internal document. The guidelines offer tips that include moving irate customers away from others, using the customer's name frequently and offering a sincere apology, with suggested language like, "I can understand how you feel, and I am very sorry," according to the memo.

McDonald's owner/operators say that Greenberg's efforts aren't enough. "The franchisees are in a kind of malaise," says Dick Adams, who represents about 400 McDonald's operators as president of Consortium, a San Diego-based advocacy group.

"Oak Brook is in a time warp, trying to force growth into the system like it was 1992." Franchisees are miffed that McDonald's is taking more in fees. McDonald's assesses some operating costs to its franchisees and takes its cash off the top.

Through the years, McDonald's has taken increasingly bigger slices of gross sales. In 1990, the company collected 11.5 percent in rent plus a service fee, according to Adams.

By decade's end, it was collecting 15 percent to 20 percent, he says. Spokeswoman Rozenich disputes that fees are as high as 15 percent. She says they range from 11.5 percent in the US to about 13 percent overseas.

Ballooning debt

With stock prices down, Greenberg is betting that McDonald's shares, which trade at 20 times estimated earnings, are undervalued. He's spent US$3.3 billion of the US$4.5 billion the company is authorized to spend on stock buybacks. Cash flow paid for a portion, and he borrowed the rest, ballooning debt to US$8.5 billion in 2000 from US$7.3 billion in 1999.

Moody's Investors Service and Standard & Poor's have reduced their outlooks for the company's debt.

Moody's senior analyst Peggy Holloway changed her rating outlook to "negative" from "stable" on March 1, 2000, because of slowing growth. She reiterated the negative outlook on Sept. 4.

Standard & Poor's Corporate Ratings Director Gerald Hirschberg changed his outlook to "negative" from "stable" in April 2000, after the McDonald's board approved the buyback program. "It leaves a little less money to pay debt, especially during times when the business may not be faring as well," he says.

Cash flow dropped to US$800 million in 2000 from US$1.1 billion in 1999. McDonald's has an AA credit rating, two notches below the highest, AAA.

Greenberg says he won't accept that McDonald's is no longer a fast-growing company.

"We won't be satisfied until we continuously deliver the double-digit growth you have come to expect as McDonald's shareholders," he said in the June 15 teleconference.

Analysts doubt that will happen. "The recent past shows that double-digit earnings growth is pretty difficult for McDonald's," says Banc of America Securities analyst Andrew Barish, who rates McDonald's a "market perform."

In the end, Greenberg is struggling with food quality, customer service and the pace of growth, while such competitors as Burger King and Wendy's are pleasing customers more.

Unless he can fix the company's troubles fast, his market share has only one way to go -- down.