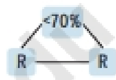
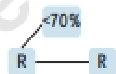
EXHIBIT 8.8 / Four Main Types of Diversification

Revenues from Primary Business	Type of Diversification	Competencies (in products, services, technology or distribution)	Examples	Graphic
>95%	Single business	Single business leverages its competencies.	Birkenstock Coca-Cola Facebook	
70%–95%	Dominant business	Dominant and minor businesses share competencies.	Harley-Davidson Nestlé UPS	
	Related Diversification			
	Related-constrained	Businesses generally share competencies.	ExxonMobil Johnson & Johnson Nike	
<70%	Related-linked	Some businesses share competencies.	Amazon Disney GE	
	Unrelated diversification (conglomerate)	Businesses share few, if any, competencies.	Samsung Berkshire Hathaway Yamaha	

NOTE: *R* = Remainder revenue, generally in other strategic business units (SBU) within the firm.

SOURCE: Adapted from R.P. Rumelt (1974), *Strategy, Structure, and Economic Performance* (Boston, MA: Harvard Business School Press).

Exhibit 8.8 summarizes the four main types of diversification—single business, dominant business, related diversification (including its subcategories related-constrained and related-linked diversification), and unrelated diversification.

LEVERAGING CORE COMPETENCIES FOR CORPORATE DIVERSIFICATION

LO 8-8

Apply the core competence–market matrix to derive different diversification strategies.

In Chapter 4, when looking inside the firm, we introduced the idea that competitive advantage can be based on core competencies. Core competencies are unique strengths embedded deep within a firm. They allow companies to increase the perceived value of their product and service offerings and/or lower the cost to produce them.[64] Examples of core competencies are

- Walmart's ability to effectively orchestrate a globally distributed supply chain at low cost.
- Infosys' ability to provide high-quality information technology services at a low cost by leveraging its global delivery model. This implies taking work to the location where it makes the best economic sense, based on the available talent and the least amount of acceptable risk and lowest cost.

To survive and prosper, companies need to grow. This mantra holds especially true for publicly owned companies, because they create shareholder value through profitable

core competence–market matrix A framework to guide corporate diversification strategy by analyzing possible combinations of existing/new core competencies and existing/new markets.

growth. Managers respond to this relentless growth imperative by leveraging their existing core competencies to find future growth opportunities. Gary Hamel and C.K. Prahalad advanced the **core competence–market matrix**, depicted in Exhibit 8.9, as a way to guide managerial decisions in regard to diversification strategies. The first task for managers is to identify their existing core competencies and understand the firm's current market situation. When applying an existing or new dimension to core competencies and markets, four quadrants emerge, each with distinct strategic implications.

The lower-left quadrant combines existing core competencies with existing markets. Here, managers must come up with ideas of how to leverage existing core competencies to improve the firm's current market position. Bank of America is one of the largest banks in the United States and has at least one customer in 50 percent of U.S. households.[65] Developed from the Bank of Italy and started in San Francisco, California, in 1904, it became the Bank of America and Italy in 1922. Over the next 60 years it grew in California and then nationally into a major banking powerhouse. And then in 1997, in what was the largest bank acquisition of its time, NationsBank bought Bank of America.

You could say that acquisitions were a NationsBank specialty. While still the North Carolina National Bank (NCNB), one of its unique core competencies was identifying, appraising, and integrating acquisition targets. In particular, it bought smaller banks to supplement its organic growth throughout the 1970s and '80s, and from 1989 to 1992, NCNB purchased over 200 regional community and thrift banks to further improve its market position. It then turned its core competency to national banks, with the goal of becoming the first nationwide bank. Known as NationsBank in the 1990s, it purchased Barnett Bank, BankSouth, FleetBank, LaSalle, CountryWide Mortgages, and its eventual namesake, Bank of America. This example illustrates how NationsBank, rebranded as Bank of America since 1998, honed and deployed its core competency of selecting, acquiring, and integrating other commercial banks to grow dramatically in size and geographic scope and emerge as one of the leading banks in the United States. As a key vehicle of corporate strategy, we study acquisitions in more detail in Chapter 9.

The lower-right quadrant of Exhibit 8.9 combines existing core competencies with new market opportunities. Here, leaders must strategize about how to redeploy and recombine existing core competencies to compete in future markets. During the global financial crisis in 2008, Bank of America bought the investment bank Merrill Lynch for $50 billion.[66] Although many problems ensued for Bank of America following the Merrill Lynch acquisition, it is now the bank's investment and wealth management division. Bank of America's corporate managers applied an existing competency (acquiring and integrating) into a new market (investment and wealth management). The combined entity is now leveraging economies of scope through cross-selling when, for example, consumer banking makes customer referrals for investment bankers to follow up.[67]

EXHIBIT 8.9 / The Core Competence–Market Matrix

SOURCE: Adapted from G. Hamel and C.K. Prahalad (1994), *Competing for the Future* (Boston, MA: Harvard Business School Press).

The upper-left quadrant combines new core competencies with existing market opportunities. Here, managers must come up with strategic initiatives to build new core competencies to protect and extend the company's current market position. For example, in the early 1990s, Gatorade dominated the market for sports drinks, a segment in which it had been the original innovator. Some 25 years earlier, medical researchers at the University of Florida had created the drink to enhance the performance of the Gators, the university's football team, thus the name Gatorade. Stokely-Van Camp commercialized and marketed the drink, and eventually sold it to Quaker Oats. PepsiCo brought Gatorade into its lineup of soft drinks when it acquired Quaker Oats in 2001.

By comparison, Coca-Cola had existing core competencies in marketing, bottling, and distributing soft drinks, but had never attempted to compete in the sports-drink market. Over a 10-year R&D effort, Coca-Cola developed competencies in the development and marketing of its own sports drink, Powerade, which launched in 1990. In 2015, Powerade held about 20 percent of the sports-drink market, making it a viable competitor to Gatorade, which still holds close to 80 percent of the market.[68]

Finally, the upper-right quadrant combines new core competencies with new market opportunities. Hamel and Prahalad call this combination "mega-opportunities"—those that hold significant future-growth opportunities. At the same time, it is likely the most challenging diversification strategy because it requires building new core competencies to create and compete in future markets.

Salesforce.com, for example, is a company that employs this diversification strategy well.[69] In recent years, Salesforce experienced tremendous growth, the bulk of it coming from the firm's existing core competency in delivering customer relationship management (CRM) software to its clients. Salesforce's product distinguished itself from the competition by providing software as a service via cloud computing: Clients did not need to install software or manage any servers, but could easily access the CRM through a web browser (a business model called *software as a service*, or *SaaS*). In 2007, Salesforce recognized an emerging market for *platform as a service* (*PaaS*) offerings, which would enable clients to build their own software solutions that are accessed the same way as the Salesforce CRM. Seizing the opportunity, Salesforce developed a new competency in delivering software development and deployment tools that allowed its customers to either extend their existing CRM offering or build completely new types of software. Today, Salesforce's Force.com offering is one of the leading providers of PaaS tools and services.

Taken together, the core competence–market matrix provides guidance to executives on how to diversify in order to achieve continued growth. Once managers have a clear understanding of their firm's core competencies (see Chapter 4), they have four options to formulate corporate strategy:

Four Options to Formulate Corporate Strategy via Core Competencies

1. Leverage existing core competencies to improve current market position.
2. Build new core competencies to protect and extend current market position.
3. Redeploy and recombine existing core competencies to compete in markets of the future.
4. Build new core competencies to create and compete in markets of the future.

CORPORATE DIVERSIFICATION AND FIRM PERFORMANCE

LO 8-9

Explain when a diversification strategy does create a competitive advantage and when it does not.

Corporate managers pursue diversification to gain and sustain competitive advantage. But does corporate diversification indeed lead to superior performance? To answer this question, we need to evaluate the performance of diversified companies. The critical question to ask when doing so is whether the individual businesses are worth more under the company's management than if each were managed individually.

The diversification-performance relationship is a function of the underlying type of diversification. A cumulative body of research indicates an inverted U-shaped relationship between the type of diversification and overall firm performance, as depicted in Exhibit 8.10.[70] High and low levels of diversification are generally associated with lower overall performance, while moderate levels of diversification are associated with higher firm performance. This implies that companies that focus on a single business, as well as companies that pursue unrelated diversification, often fail to achieve additional value creation. Firms that compete in single markets could potentially benefit from economies of scope by leveraging their core competencies into adjacent markets.

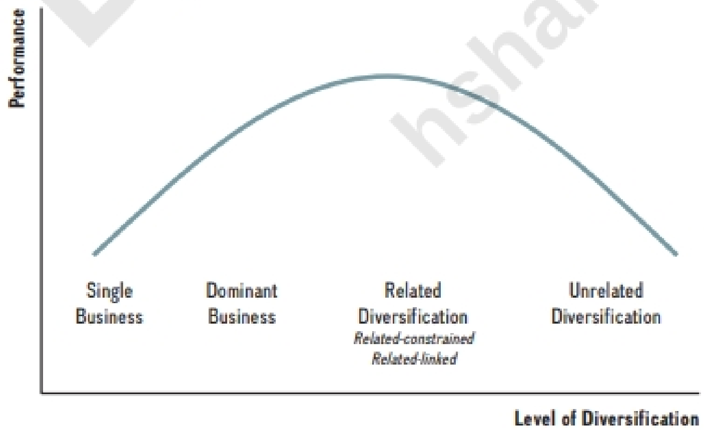
diversification discount Situation in which the stock price of highly diversified firms is valued at less than the sum of their individual business units.

Firms that pursue unrelated diversification are often unable to create additional value. They experience a **diversification discount**: The stock price of such highly diversified firms is valued at less than the sum of their individual business units.[71] For the last decade or so, GE experienced a diversification discount, as its capital unit contributed 50 percent of profits on one-third of the conglomerate's revenues. The presence of the diversification discount in GE's depressed stock price was a major reason GE's then CEO, Jeffrey Immelt, decided in 2015 to spin out GE Capital. On the day of the announcement, GE's stock price jumped 11 percent, adding some $28 billion to GE's market capitalization. This provides some idea of the diversification discount that firms pursuing unrelated diversification may experience.[72] Through this restructuring of the corporate portfolio, GE is now better positioned to focus more fully on its core competencies in industrial engineering and management processes.

diversification premium Situation in which the stock price of related-diversification firms is valued at greater than the sum of their individual business units.

The presence of the diversification discount, however, depends on the institutional context. Although it holds in developed economies with developed capital markets, some research evidence suggests that an unrelated diversification strategy can be advantageous in emerging economies as mentioned when discussing Tata in Strategy Highlight 8.2.[73] Here, unrelated diversification may help firms gain and sustain competitive advantage because it allows the conglomerate to overcome institutional weaknesses in emerging economies such as a lack of a functioning capital market.

EXHIBIT 8.10 / The Diversification-Performance Relationship



SOURCE: Adapted from L.E. Palich, L.B. Cardinal, and C.C. Miller (2001), "Curvilinearity in the diversification-performance linkage: An examination of over three decades of research," *Strategic Management Journal* 21: 155–174.

In contrast, companies that pursue related diversification are more likely to improve their performance. They create a **diversification premium**: The stock price of related-diversification firms is valued at greater than the sum of their individual business units.[74]

Why is this so? At the most basic level, a corporate diversification strategy enhances firm performance when its value creation is greater than the costs it incurs. Exhibit 8.11 lists the sources of value creation and costs for different corporate strategies, for vertical integration as well as related and unrelated diversification. For diversification to enhance firm performance, it must do at least one of the following:

EXHIBIT 8.11 Vertical Integration and Diversification: Sources of Value Creation and Costs

Corporate Strategy	Sources of Value Creation (V)	Sources of Costs (C)
Vertical Integration	• Can lower costs • Can improve quality • Can facilitate scheduling and planning ——— • Facilitating investments in specialized assets • Securing critical supplies and distribution channels	• Can increase costs • Can reduce quality • Can reduce flexibility ——— • Increasing potential for legal repercussions
Related Diversification	• Economies of scope • Economies of scale • Financial economies ■ Restructuring ■ Internal capital markets	• Coordination costs • Influence costs
Unrelated Diversification	• Financial economies ■ Restructuring ■ Internal capital markets	• Influence costs

- Provide *economies of scale*, which reduces costs.
- Exploit *economies of scope*, which increases value.
- Reduce costs *and* increase value.

We discussed these drivers of competitive advantage—economies of scale, economies of scope, and increase in value and reduction of costs—in depth in Chapter 6 in relation to business strategy. Other potential benefits to firm performance when following a diversification strategy include *financial economies*, resulting from *restructuring* and using *internal capital markets*.

RESTRUCTURING. *Restructuring* describes the process of reorganizing and divesting business units and activities to refocus a company to leverage its core competencies more fully. The Belgium-based Anheuser-Busch InBev sold Busch Entertainment, its theme park unit that owns SeaWorld and Busch Gardens, to a group of private investors for roughly \$3 billion. This strategic move allows InBev to focus more fully on its core business of brewing and distributing beer across the world.[75]

Corporate executives can restructure the portfolio of their firm's businesses, much like an investor can change a portfolio of stocks. One helpful tool to guide corporate portfolio planning is the **Boston Consulting Group (BCG) growth–share matrix**, shown in Exhibit 8.12.[76] This matrix locates the firm's individual SBUs in two dimensions:

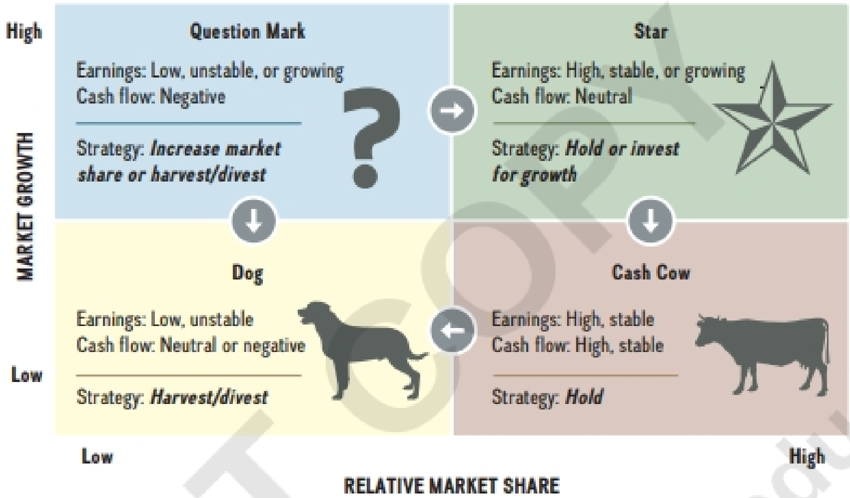
- Relative market share (horizontal axis).
- Speed of market growth (vertical axis).

Boston Consulting Group (BCG) growth–share matrix A corporate planning tool in which the corporation is viewed as a portfolio of business units, which are represented graphically along relative market share (horizontal axis) and speed of market growth (vertical axis). SBUs are plotted into four categories (dog, cash cow, star, and question mark), each of which warrants a different investment strategy.

The firm plots its SBUs into one of four categories in the matrix: *dog, cash cow, star,* and *question mark*. Each category warrants a different investment strategy. All four categories shape the firm's corporate strategy.

SBUs identified as *dogs* are relatively easy to identify: They are the underperforming businesses. Dogs hold a small market share in a low-growth market; they have low and

EXHIBIT 8.12 Restructuring the Corporate Portfolio: The Boston Consulting Group Growth–Share Matrix



unstable earnings, combined with neutral or negative cash flows. The strategic recommendations are either to *divest* the business or to *harvest* it. This implies stopping investment in the business and squeezing out as much cash flow as possible before shutting it or selling it.

Cash cows, in contrast, are SBUs that compete in a low-growth market but hold considerable market share. Their earnings and cash flows are high and stable. The strategic recommendation is to invest enough into cash cows to hold their current position and to avoid having them turn into dogs (as indicated by the arrow in Exhibit 8.12). As a general rule, strategic leaders would want to manage their SBU portfolio in a clockwise manner (as indicated by three of the four arrows).

A corporation's *star* SBUs hold a high market share in a fast-growing market. Their earnings are high and either stable or growing. The recommendation for the corporate strategist is to invest sufficient resources to hold the star's position or even increase investments for future growth. As indicated by the arrow, stars may turn into cash cows as the market in which the SBU is situated slows after reaching the maturity stage of the industry life cycle.

Finally, some SBUs are *question marks:* It is not clear whether they will turn into dogs or stars (as indicated by the arrows in Exhibit 8.12). Their earnings are low and unstable, but they might be growing. The cash flow, however, is negative. Ideally, corporate executives want to invest in question marks to increase their relative market share so they turn into stars. If market conditions change, however, or the overall market growth slows, then a question-mark SBU is likely to turn into a dog (as indicated by the arrow). In this case, executives would want to harvest the cash flow or divest the SBU.

INTERNAL CAPITAL MARKETS. *Internal capital markets* can be a source of value creation in a diversification strategy if the conglomerate's headquarters does a more efficient job of allocating capital through its budgeting process than what could be achieved in external capital markets. Based on private information, corporate managers are in a position to discover which of their strategic business units will provide the highest return on invested capital. In addition, internal capital markets may allow the company to access capital at a lower cost.

Until recently, for example, GE Capital brought in close to $70 billion in annual revenues and generated more than half of GE's profits.[77] In combination with GE's triple-A debt rating, having access to such a large finance arm allowed GE to benefit from a lower cost of capital, which in turn was a source of value creation in itself. In 2009, at the height of the global financial crises, GE lost its AAA debt rating. The lower debt rating and the smaller finance unit were likely to result in a higher cost of capital, and thus a potential loss in value creation through internal capital markets. As mentioned above, GE sold its GE Capital business unit in 2015 in a restructuring of its corporate portfolio.

A strategy of related-constrained or related-linked diversification is more likely to enhance corporate performance than either a single or dominant level of diversification or an unrelated level of diversification. The reason is that the sources of value creation include not only restructuring, but also the potential benefits of economies of scope and scale. To create additional value, however, the benefits from these sources of incremental value creation must outweigh their costs. A related-diversification strategy entails two types of costs: coordination and influence costs. *Coordination costs* are a function of the number, size, and types of businesses that are linked. *Influence costs* occur due to political maneuvering by managers to influence capital and resource allocation and the resulting inefficiencies stemming from suboptimal allocation of scarce resources.[78]

8.5 Implications for Strategic Leaders

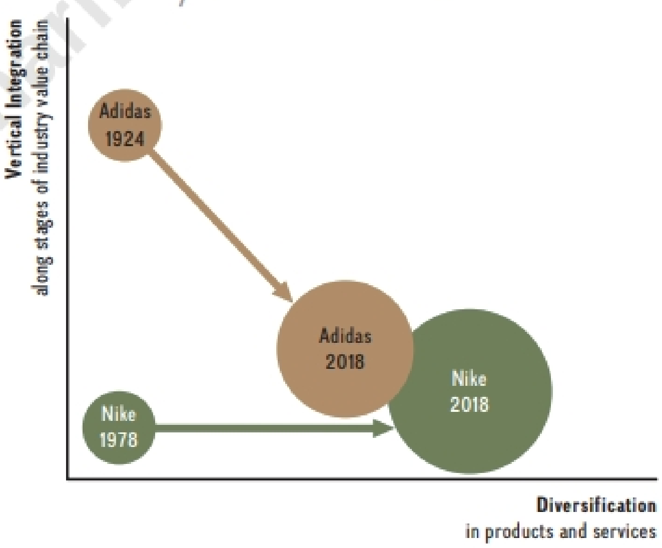
An effective corporate strategy increases a firm's chances to gain and sustain a competitive advantage. By formulating corporate strategy, strategic leaders make important choices along three dimensions that determine the boundaries of the firm:

- **The degree of vertical integration**—in what stages of the industry value chain to participate.
- **The type of diversification**—what range of products and services to offer.
- **The geographic scope**—where to compete.

Since a firm's external environment never remains constant over time, *corporate strategy needs to be dynamic over time*. As firms grow, they tend to diversify and globalize to capture additional growth opportunities. Exhibit 8.13 shows the dynamic nature of corporate strategy through decisions made by two top competitors in the sports footwear and apparel industry: Nike and Adidas.

Adidas was founded in 1924 in Germany. It began its life in the laundry room of a small apartment. Two brothers focused on one product: athletic shoes. Initially, Adidas was a fairly integrated manufacturer of athletic shoes. The big breakthrough for the company came in 1954 when the underdog West Germany won the soccer World Cup in Adidas cleats. As the world markets globalized and became more competitive in the

EXHIBIT 8.13 / Dynamic Corporate Strategy: Nike vs. Adidas



decades after World War II, Adidas not only vertically disintegrated to focus mainly on the design of athletic shoes but also diversified into sports apparel. Adidas' annual revenues are $21 billion. It is a diversified company active across the globe in sports shoes (40 percent of revenues), sports apparel (50 percent of revenues), and sports equipment (10 percent of revenues). The change in Adidas' corporate strategy from a small, highly integrated single business to a disintegrated and diversified global company is shown in Exhibit 8.13.

Nike is the world's leader in sports shoes and apparel with annual sales of $34 billion. Founded in 1978, and thus much younger than Adidas, Nike was vertically disintegrated from the very beginning. After moving beyond importing Japanese ASICS shoes to the United States, Nike focused almost exclusively on R&D, design, and marketing of running shoes. Although Nike diversified into different lines of business, it stayed true to its vertical disintegration by focusing on only a few activities (see Exhibit 8.13). Nike is a global company and its revenues come from sports shoes (50 percent) and apparel (25 percent), as well as sports equipment and other businesses, such as affiliate brands Cole Haan, Converse, Hurley, and Umbro.

The changes in the strategic positions shown in Exhibit 8.13 highlight the dynamic nature of corporate strategy. Also, keep in mind that the relationship between diversification strategy and competitive advantage depends on the *type of diversification*. There exists an inverted U-shaped relationship between the level of diversification and performance improvements. On average, related diversification (either related-constrained or related-linked such as in the Nike and Adidas example) is most likely to lead to superior performance because it taps into multiple sources of value creation (economies of scale and scope; financial economies). To achieve a net positive effect on firm performance, however, related diversification must overcome additional sources of costs such as coordination and influence costs.

In the next chapter, we discuss strategic alliances in more depth as well as mergers and acquisitions, both are critical tools in executing corporate strategy. In Chapter 10, we take a closer look at geographic diversification by studying how firms compete for competitive advantage around the world.

CHAPTER**CASE 8** / Consider This. . .

ALTHOUGH AMAZON is one of the largest technology companies globally in terms of its stock market valuation, several problems loom at the horizon. Amazon's annual revenues are some $140 billion, but consistent profitability continues to elude the company. Moreover, as technology has evolved, traditional boundaries between hardware and software, products and services, and online and brick-and-mortar stores have become increasingly blurred. As a result, Amazon finds itself engaged in a fierce competitive battle for control of the emerging digital ecosystem, pitted against technology giants such as Apple, Alphabet, and Facebook. In retailing Amazon competes with Walmart and the Chinese ecommerce company Alibaba. In data services and cloud computing, it competes with Microsoft, IBM, and others. Indeed, the list of Amazon's competitors keeps increasing rapidly, as this passage from its 2016 annual report makes clear:[79]

©Mike Kane/Bloomberg/ Getty Images

"Our businesses encompass a large variety of product types, service offerings, and delivery channels. . . . [W]e face a broad array of competitors from many different industry sectors around the world [including]: (1) online, offline, and multichannel retailers, publishers, vendors, distributors, manufacturers, and producers of the products we offer. . .; (2) publishers, producers, and distributors of physical, digital, and interactive media of all types and all distribution channels; (3) web search engines, comparison shopping websites, social networks, [and] web portals. . .; (4) companies that provide ecommerce services. . .; (5) companies that provide fulfillment and logistics services. . .online or offline; (6) companies that provide information technology services or products. . .; and (7) companies that design, manufacture, market, or sell consumer electronics, telecommunication, and electronic devices."

Even Amazon's 2017 acquisition (spending close to $14 billion, more than any previous acquisition) on high-end grocer Whole Foods raises as many potential problems as opportunities. With the purchase, Amazon is likely looking to maximize a hybrid of online sales with physical delivery points, and use its huge data stockpile to reverse-engineer the retail experience in the grocery space. There are also suggestions that Amazon's ability to squeeze labor costs out of an operation and to operate for extended periods at a loss provides an opportunity to push competitors into an area where they won't be able to compete effectively. However, we don't know how well Amazon's tactics will succeed. And the grocery industry has shown itself to be fiercely competitive in the past. In terms of opportunities, the purchase of Whole Foods Market allows Amazon to compete more effectively with Walmart, which is the largest grocer in the United States, and has been quite successful with its hybrid approach to retailing, combining online purchases with same day in-store pick-ups.[80]

Questions

1. Describe Amazon's diversification strategy using Exhibit 8.8. What type of diversification strategy is Amazon pursuing? Explain.
2. What is Amazon's core business? Is AWS related to Amazon's core business? Why or why not? Some investors are pressuring Jeff Bezos to spin out AWS as a standalone company. Do you agree with this corporate strategy recommendation? Why or why not? Hint: Do you believe AWS would be more valuable within Amazon or as a standalone company?
3. Amazon.com is now 25 years old and makes $140 billion in annual revenues. As an investor, would it concern you that Amazon.com has yet to deliver any consistent profits? Why or why not? How much longer do you think investors will be patient with Jeff Bezos as he continues to pursue billion-dollar diversification initiatives?
4. Amazon.com continues to spend billions on seemingly unrelated diversification efforts. Do you believe these efforts contribute to Amazon gaining and sustaining a competitive advantage? Why or why not?

TAKE-AWAY CONCEPTS

This chapter defined corporate strategy and then looked at two fundamental corporate strategy topics—vertical integration and diversification—as summarized by the following learning objectives and related take-away concepts.

LO 8-1 / Define corporate strategy and describe the three dimensions along which it is assessed.

- Corporate strategy addresses "where to compete." Business strategy addresses "how to compete."
- Corporate strategy concerns the boundaries of the firm along three dimensions: (1) industry value chain, (2) products and services, and (3) geography (regional, national, or global markets).
- To gain and sustain competitive advantage, any corporate strategy must support and strengthen a firm's strategic position, regardless of whether it is a differentiation, cost-leadership, or blue ocean strategy.

LO 8-2 / Explain why firms need to grow, and evaluate different growth motives.

- Firm growth is motivated by the following: increasing profits, lowering costs, increasing market power, reducing risk, and managerial motives.
- Not all growth motives are equally valuable.
- Increasing profits and lowering expenses are clearly related to enhancing a firm's competitive advantage.

- Increasing market power can also contribute to a greater competitive advantage, but can also result in legal repercussions such as antitrust lawsuits.
- Growing to reduce risk has fallen out of favor with investors, who argue that they are in a better position to diversify their stock portfolio in comparison to a corporation with a number of unrelated strategic business units.
- Managerial motives such as increasing company perks and job security are not legitimate reasons a firm needs to grow.

LO 8-3 / Describe and evaluate different options firms have to organize economic activity.

- Transaction cost economics help managers decide what activities to do in-house ("make") versus what services and products to obtain from the external market ("buy").
- When the costs to pursue an activity in-house are less than the costs of transacting in the market ($C_{\text{in-house}} < C_{\text{market}}$), then the firm should vertically integrate.
- Principal–agent problems and information asymmetries can lead to market failures, and thus situations where internalizing the activity is preferred.
- A principal–agent problem arises when an agent, performing activities on behalf of a principal, pursues his or her own interests.
- Information asymmetries arise when one party is more informed than another because of the possession of private information.
- Moving from less integrated to more fully integrated forms of transacting, alternatives include short-term contracts, strategic alliances (including long-term contracts, equity alliances, and joint ventures), and parent–subsidiary relationships.

LO 8-4 / Describe the two types of vertical integration along the industry value chain: backward and forward vertical integration.

- Vertical integration denotes a firm's addition of value—what percentage of a firm's sales is generated by the firm within its boundaries.
- Industry value chains (vertical value chains) depict the transformation of raw materials into finished goods and services. Each stage typically represents a distinct industry in which a number of different firms compete.
- Backward vertical integration involves moving ownership of activities upstream nearer to the originating (inputs) point of the industry value chain.
- Forward vertical integration involves moving ownership of activities closer to the end (customer) point of the value chain.

LO 8-5 / Identify and evaluate benefits and risks of vertical integration.

- Benefits of vertical integration include securing critical supplies and distribution channels, lowering costs, improving quality, facilitating scheduling and planning, and facilitating investments in specialized assets.
- Risks of vertical integration include increasing costs, reducing quality, reducing flexibility, and increasing the potential for legal repercussions.

LO 8-6 / Describe and examine alternatives to vertical integration.

- Taper integration is a strategy in which a firm is backwardly integrated but also relies on outside-market firms for some of its supplies, and/or is forwardly integrated but also relies on outside-market firms for some if its distribution.
- Strategic outsourcing involves moving one or more value chain activities outside the firm's boundaries to other firms in the industry value chain. Offshoring is the outsourcing of activities outside the home country.

LO 8-7 / Describe and evaluate different types of corporate diversification.

- A single-business firm derives 95 percent or more of its revenues from one business.
- A dominant-business firm derives between 70 and 95 percent of its revenues from a single business, but pursues at least one other business activity.
- A firm follows a related diversification strategy when it derives less than 70 percent of its revenues from a single business activity, but obtains revenues from other lines of business that are linked to the primary business activity. Choices within a related diversification strategy can be related-constrained or related-linked.
- A firm follows an unrelated diversification strategy when less than 70 percent of its revenues come from a single business, and there are few, if any, linkages among its businesses.

LO 8-8 / Apply the core competence–market matrix to derive different diversification strategies.

- When applying an existing/new dimension to core competencies and markets, four quadrants emerge, as depicted in Exhibit 8.9.
- The lower-left quadrant combines existing core competencies with existing markets. Here, managers need to come up with ideas of how to leverage existing core competencies to improve their current market position.
- The lower-right quadrant combines existing core competencies with new market opportunities. Here, managers need to think about how to redeploy and recombine existing core competencies to compete in future markets.
- The upper-left quadrant combines new core competencies with existing market opportunities. Here, managers must come up with strategic initiatives of how to build new core competencies to protect and extend the firm's current market position.
- The upper-right quadrant combines new core competencies with new market opportunities. This is likely the most challenging diversification strategy because it requires building new core competencies to create and compete in future markets.

LO 8-9 / Explain when a diversification strategy does create a competitive advantage and when it does not.

- The diversification-performance relationship is a function of the underlying type of diversification.
- The relationship between the type of diversification and overall firm performance takes on the shape of an inverted U (see Exhibit 8.10).
- Unrelated diversification often results in a diversification discount: The stock price of such highly diversified firms is valued at less than the sum of their individual business units.
- Related diversification often results in a diversification premium: The stock price of related-diversification firms is valued at greater than the sum of their individual business units.
- In the BCG matrix, the corporation is viewed as a portfolio of businesses, much like a portfolio of stocks in finance (see Exhibit 8.12). The individual SBUs are evaluated according to relative market share and the speed of market growth, and are plotted using one of four categories: dog, cash cow, star, and question mark. Each category warrants a different investment strategy.
- Both low levels and high levels of diversification are generally associated with lower overall performance, while moderate levels of diversification are associated with higher firm performance.

KEY TERMS

Backward vertical integration *(p. 280)*
Boston Consulting Group (BCG) growth–share matrix *(p. 295)*
Conglomerate *(p. 289)*
Core competence–market matrix *(p. 292)*
Corporate strategy *(p. 268)*
Credible commitment *(p. 277)*
Diversification *(p. 287)*
Diversification discount *(p. 294)*
Diversification premium *(p. 294)*
External transaction costs *(p. 271)*
Forward vertical integration *(p. 281)*
Franchising *(p. 275)*
Geographic diversification strategy *(p. 287)*
Industry value chain *(p. 278)*
Information asymmetry *(p. 274)*
Internal transaction costs *(p. 271)*
Joint venture *(p. 277)*
Licensing *(p. 275)*
Principal–agent problem *(p. 273)*
Product diversification strategy *(p. 287)*
Product–market diversification strategy *(p. 287)*
Related-constrained diversification strategy *(p. 288)*
Related diversification strategy *(p. 288)*
Related-linked diversification strategy *(p. 289)*
Specialized assets *(p. 282)*
Strategic alliances *(p. 275)*
Strategic outsourcing *(p. 285)*
Taper integration *(p. 284)*
Transaction cost economics *(p. 271)*
Transaction costs *(p. 271)*
Unrelated diversification strategy *(p. 289)*
Vertical integration *(p. 278)*
Vertical market failure *(p. 284)*

DISCUSSION QUESTIONS

1. When Walmart decided to incorporate grocery stores into some locations and created "supercenters," was this a business-level strategy of differentiation or a corporate strategy of diversification? Why? Explain your answer.
2. How can related diversification create a competitive advantage for the firm? Keeping the advantages of related diversification in mind, think back to the example of Delta's vertical integration decision to acquire an oil refinery—clearly an unrelated diversification move. What challenges might Delta confront in operating this refinery? Think of the strategic concepts you have learned and how they can help you evaluate Delta's decision.
3. Franchising is widely used in the casual dining and fast food industry, yet Starbucks is quite successful with a large number of company-owned stores. In 2016 Starbucks had more than 7,800 company-owned stores in the United States. How do you explain this difference? Is Starbucks bucking the trend of other food-service stores, or is something else going on?

ETHICAL/SOCIAL ISSUES

1. The chapter notes that some firms choose to outsource their human resource management systems. If a firm has a core value of respecting its employees and rewarding top performance with training, raises, and promotions, does outsourcing HR management show a lack of commitment by the firm? HR management systems are software applications that typically manage payroll, benefits, hiring and training, and performance appraisal. What are the advantages and disadvantages of this decision? Think of ways that a firm can continue to show its commitment to treat employees with respect.
2. Nike is a large and successful firm in the design of athletic shoes. It could easily decide to forward-integrate to manufacture the shoes it designs. Therefore, the firm has a credible threat over its current manufacturers. If Nike has no intention of actually entering the manufacturing arena, is its supply chain management team being ethical with the current manufacturers if the team mentions this credible threat numerous times in annual pricing negotiations? Why or why not?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

Agriculture is one of the largest and oldest industries in the world. In the United States and many other countries, farmers often struggle to turn a profit given the variabilities of weather and commodity prices. Some working farms are turning to tourism as an additional and complementary revenue source. A study from the U.S. Census of Agriculture in 2012 found over 13,000 farms generated $674 million in revenues from tourist and recreational activities. This is a 23 percent jump over revenues in the prior agricultural census in 2007. In 2014, in response to rapid growth, the National Agritourism Professionals Association was formed to help farmers learn how to add this aspect of business to their traditional farms and ranches.

One of the most successful large companies leading this marriage of industries is a dairy farm in Indiana: Fair Oaks Farms (www.fofarms.com) is home to 37,000 cows and produces enough milk to feed over 8 million people. Fair Oaks is also participating in the education market as a popular destination for school field trips. Other attractions include the Birthing Barn, where calf births can be viewed live; the Cheese Factory; and Mooville, a themed outdoor play area. Fair Oaks grew beyond the dairy and added a Pig Adventure in 2014 and a Crop Adventure in 2016. Each year, Fair Oaks Farms hosts more than 600,000 visitors including 50,000 kids on school field trips A video of the operation by the CEO is available at https://www.youtube.com/watch?v=Dz_gE4887so. Such ingenious business diversification can offer many benefits to the agriculture industry.[81]

1. What other industrial or commercial industries could benefit from such potential tourist or recreational revenues? Discuss what new and complementary capabilities would need to be developed in order to succeed.
2. In your group, list other industry combinations you have seen be successful. Consider why you think the combination has been a success.

//// Small Group Exercise 2

The ChapterCase 8 opener mentioned Amazon's Campus initiative. It was developed to compete directly with university bookstores. This is a good corporate strategy for Amazon for many reasons—among them, it provides the company deeper access into the shopping behavior of college students, as well as of their media viewing purchases and habits. It also represents another large competitive threat to Barnes & Noble, which runs more than 700 campus bookstores. To make it beneficial for universities to partner with Amazon, Amazon pays the schools between 0.5 and 2.5 percent of all Amazon purchases made through the university website. Purdue University, one of the first universities to sign on, reportedly has made $1 million from Amazon in the first two years of the program. Sixteen campuses had signed up by the end of 2016 with rapid continued growth expected.

In August 2015 Barnes & Noble spun off its college bookstore unit into a separate company called Barnes & Noble Education (BNED on the NYSE). The firm stated the split allows each business to focus on its core. Barnes & Noble will focus on the consumer retail business, which has suffered from online shopping and digital books. The new firm will focus on the higher education market, putting it perhaps in a better position to seek acquisitions on its own.

1. In your small group, discuss any potential ethical issues with Amazon paying the university administration for direct access into the school's course textbook system.
2. While Amazon as a firm continues to diversify its products, services, and markets under one corporate umbrella, why do firms such as Barnes & Noble choose to split into separate firms for greater focus on each piece of the business? Do these different strategies align with the core competencies of each? It may be helpful to review Exhibit 8.9.
3. If your team was asked to consult for Barnes & Noble Education, which corporate strategies would you recommend to the company's senior leadership?

*my*STRATEGY

How Diversified Are You?

Corporations diversify by investing time and resources into new areas of business. As individuals, each of us makes choices about how to spend our time and energies. Typically, we could divide our time between school, work, family, sleep, and play. During high-stress work projects, we likely devote more of our time to work; when studying for final exams or a professional board exam (such as the CPA exam), we probably spend more time and effort in the "student learning" mode. This manner of dividing our time can be thought of as "personal diversification." Just as companies can invest in related or unrelated activities, we make similar choices. While we attend college, we may choose to engage in social and leisure activities with campus colleagues, or we may focus on classwork at school and spend our "play time" with an entirely separate set of people.

Using Exhibit 8.8 as a guide, list each of your major activity areas. Think of each of these as a business. (If you are literally "all work and no play," you are a single-business type of personal diversification.) Instead of revenues, estimate the percentage of *time you* spend per week in each activity. (Most people will be diversified, though some may be dominant perhaps in school or work.) To assess your degree of *relatedness* and *unrelatedness*, consider the subject matter and community involved with each activity. For example, if you are studying ballet and working as an accountant, those would be largely unrelated activities (unless you are an accountant for a ballet company!).

1. What conclusions do you derive based on your personal diversification strategy?
2. Do you need to make adjustments to your portfolio of activities? Explain the reasons for your answer.
3. Let's consider dynamics—has your level of diversification changed over time (say, over the last five years)? Looking toward the future, do you expect your level of diversification to change as you complete your degree? Why or why not?

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FRANK T. ROTHAERMEL
JOHN KIM

McDonald's Corporation

September 1, 2017. Steve Easterbrook walked into his office in the McDonald's corporate headquarters in Oak Brook, Illinois. Now two and a half years into the job of McDonald's CEO, he is starting to see some of his early turnaround initiatives show results.

His thoughts turned to Don Thompson, his predecessor and friend. Thompson was in the top job for less than three years, overseeing a more than four percent decline in customer traffic in 2014. In spring 2015, Thompson retired. Easterbrook hoped to avoid this fate. They had both started their careers at McDonald's early in the 1990s and had climbed the corporate ladder together. Easterbrook had not taken personal joy in seeing either his friend and mentor, or the company they both loved, struggle. Rather, he had hoped to take the helm at the company at its peak and then take it to new heights—not inheriting the corporate giant in a turnaround situation.

The company's troubles had snowballed quickly. In 2011, McDonald's had outperformed nearly all its competitors while benefitting from the fallout of the great recession (2008–2010) as more customers flocked to its low-cost meal options. In fact, McDonald's was the number-one performing stock in the Dow 30 with a 34.7 percent total shareholder return.[1] But in 2012, McDonald's dropped to number 30 in the Dow 30 with a –10.75 percent annual return. The company went from first to last in twelve brief months. In 2012, McDonalds' sales growth dropped by 1.8 percent, the first monthly decline since 2003.[2] Annual system-wide sales growth in 2012 barely met the minimum three percent goal, while operating income growth was just one percent compared to a goal of six to seven percent.[3]

Things went from bad to worse. Sales continued to decline over the next two years. Net income in 2014 fell almost 15 percent to $4.76 billion, representing the company's first annual drop in "like-for-like" sales since 2002.[4] By early 2015, McDonald's shares had dropped below their 2012 price point, while the overall market was up by 50 percent.[5]

Things were not much better overseas. The weak global economy was a further drain on domestic sales.[6] When the dollar was relatively weak, it had been an asset for the company to generate almost 70 percent of its revenues from other countries, but the dollar's current strength made McDonald's trademark products even more expensive for its international consumers.[7] Asian sales were still recovering from a 2014 scandal, where a major Chinese meat supplier had been accused of selling expired meat to McDonald's restaurants. European sales were also soft due to political problems in Russia. Several McDonald's outlets had "failed" inspection and been shut down in retaliation for U.S. sanctions against Russia.[8]

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Thompson had already tried revitalizing the menu (e.g., with the McWrap), eliminating poorly selling items, increasing customization, and restructuring U.S. operations to give local franchises greater autonomy. Yet customers still seemed confused by the complex menu offerings, distrustful of the quality of ingredients, frustrated at how long it took to get their food, and angry at the company's "exploitative" labor policies.[9,10] According to analysts, "[Thompson] got fatally behind the last couple of years" and "wasn't inspiring people the way he needed to be."[11] By the fall of 2017, there was surprisingly little mention of Easterbrook in Wall Street analyst reports, seemingly indicating that he was quietly, and effectively, creating change behind the scenes.

As Steve Easterbrook took a sip from a can of a zero-calorie Monster energy drink, he looked at the screen of his laptop. He knew that early results from his strategic initiatives were promising. As of fall 2017, McDonald's (normalized) share price had appreciated by more than 55 percent since his tenure as CEO started in March 2013, outperforming the S&P 500 index by almost 35 percentage points (**Exhibits 1 and 2**). But, he wondered how he could build upon these quick wins, and create continued superior performance in an ever more uncertain and competitive environment.

A Brief History of McDonald's

McDonald's was started by the McDonald brothers in 1940 in San Bernardino, California.[12] By limiting the menu to burgers, fries, and drinks, Dick and Mac McDonald could emphasize quality and streamline their operations. As a result, the popularity of the restaurant grew quickly, and the brothers started franchising McDonald's to nearby locations. Alerted to their success when the McDonalds placed a large order for eight multi-mixers, Ray Kroc joined the brothers in 1954. Together, they founded the McDonald's Corporation in 1955, with the vision of establishing McDonald's franchises throughout the United States. Kroc bought out the brothers' shares in 1961, the same year that he founded the Hamburger University (graduates receive a bachelor's degree in Hamburgerology). He continued his plans for rapid expansion throughout the 1960s and 1970s, establishing more than 700 new McDonald's restaurants. In 1965, the company held its first public offering, debuting at $22.50 per share.

Kroc described his management philosophy as a three-legged stool: one leg was the parent corporation, the second leg was the franchisees, and the third was McDonald's suppliers. His motto became, "In business for yourself, but not by yourself," as he built an ever-larger network of store owners and an integrated supply-chain management system. Many new menu items, such as the Big Mac and Egg McMuffin, were developed by the franchisees. Kroc encouraged his local owners to be entrepreneurial as long as they maintained the company's four main principles: quality, service, cleanliness, and value. Because of the volume of McDonald's business, Kroc found many supply partners willing to adhere to his high standards.

McDonald's both owns and operates its own restaurants, as well as, franchisees them to others. The large majority of restaurants are franchised (85 percent) and McDonald's management has made it clear they expect that percentage to increase to 95 percent in the coming years. There are three primary franchise ownership structures: 1) conventional franchisee, 2) developmental license, and 3) affiliates.

Under a conventional franchise agreement, the company typically owns the land and building, and leases the location to the franchisee. The franchisee pays for "equipment, signs, seating and décor." As the equipment depreciates or new facilities or food preparation processes are required, the franchisee is expected to reinvest in the business. McDonald's also co-invests into specific strategic initiatives to motivate franchisees to adopt changes. Franchisees pay rent and royalties based on a percentage of sales, with specific minimum rent payments and initial fees paid upon opening a new restaurant or acquiring a new franchise. The typical franchisee lease is 20 years.

The specific conditions of the franchise agreement vary on the owner's experience, credit capacity, and the local legal environment. Franchisees can vary significantly in size. The largest franchisee has a developmental license for 2,200 restaurants across Latin America and the Caribbean.[13] On the other end of the spectrum, some franchisees own and operate a single location.

The company opened its first international locations in 1967 in Canada. The first McDonald's stores in Japan and Europe followed shortly thereafter in 1971. Meanwhile, Kroc continued to add new items to the restaurant's menu. After the success of the Big Mac (1968), the quarter pounder debuted in 1973, and the Egg McMuffin in 1975. A full breakfast menu was available by 1977. The first Happy Meals—complete with a circus wagon theme—arrived in 1979. The company's first drive-through opened in Sierra Vista, Arizona in 1975 to serve soldiers stationed at a nearby post, and the idea quickly spread to other locations. Competition heated up in the "burger wars" of the 1980s as Burger King and Wendy's tried to steal market share from McDonald's. Despite their advances, McDonald's continued to expand globally into more than 30 countries. Even more new products were introduced, such as Chicken McNuggets in 1983 and fresh salads in 1987. At the same time, McDonald's used efficiency and technological advances such as microwaves to gain operational advantages over its competitors.

When Ray Kroc passed away on January 14, 1984, he left behind a sprawling McDonald's empire with more than 7,500 restaurants worldwide. He stayed involved in corporate affairs up until the end, visiting the San Diego office almost daily in his wheelchair. Three years later, Fred Turner, his long-time colleague and successor as CEO, likewise stepped down and left the company in the capable hands of Michael Quinlan. As the first McDonald's CEO to have completed an MBA, Quinlan was a savvy businessperson who continued to grow the company aggressively both at home and abroad.

Events in the 1990s finally slowed McDonald's' rapid pace of domestic expansion, though the company's international locations nearly doubled to 114 from 1991 to 1998. Several of the newer locations required unique adaptations, which McDonald's proved increasingly willing to make: kosher menus in Israel, Halal menus in Arab countries, and lamb patties for non-beef-eating India.[14, 15] At home, however, the company was plagued by multiple failed attempts to add new menu items such as pizza, fried chicken, fajitas, and pasta. The Arch Deluxe sandwich line, targeted to adults, was similarly short-lived. When Jack Greenberg became CEO in 1998, he quickly took corrective action, announcing a geographic reorganization, a new food preparation system ("Made for You"), and first job cuts ever at McDonald's, all while scrapping plans for numerous store openings.[16] Instead, he diversified the company's portfolio by buying different restaurant chains such as Chipotle Mexican Grill, Donatos Pizza, Boston Market, and Aroma Cafe coffee shops.[17] These acquisitions were divested when McDonald's strategy shifted yet again in the early 2000s.

From 2003 to 2004, leadership at McDonald's underwent a rapid string of successions that would have crippled a company with a less talented executive bench. Greenberg stepped down amidst financial woes in 2003, yielding the reins to Jim Cantalupo, who died suddenly of a heart attack the next year. The board immediately named Charlie Bell to the head position after Cantalupo's death, only for Bell to be diagnosed with colorectal cancer and relinquish the post after just a few months in office. This left Jim Skinner, previously vice chairman, in charge of introducing and implementing the company's "Plan to Win" starting in late 2004.[18] The plan was based on the three pillars of "brand direction, freedom within a framework, and measurable milestones" and had four goals: to attract more customers, to convince customers to purchase more often, to increase brand loyalty, and to become more profitable. Skinner further distinguished five Ps—People, Product, Place, Price, and Promotion—as essential to efforts at McDonald's in achieving these goals.[19]

In a saturated market, the main thrust of Skinner's plan was to shift from acquiring expensive real estate to generating increased sales from existing restaurants.[20] In the early 2000s, McDonald's was opening a new store somewhere in the world every 4.5 hours; under Skinner's watch, the pace slowed to just 50 to 100 new U.S. sites per year. To compensate, existing stores started to stay open longer, extending their hours into the late night and early morning. By 2007, roughly 40 percent of McDonald's' locations were open nonstop, and some even experimented with staying open on holidays.[21, 22]

Skinner used the money saved on fewer new openings to revamp existing restaurants. The "new" McDonald's look utilized a gentler color scheme, replaced fiberglass and steel chairs with leather seating, eliminated fluorescent lighting, and added such amenities as flat-screen TVs, free Wi-Fi, live plants, piped-in music, and the occasional fireplace.[23] Headquarters provided grants of up to $600,000 per site, with some projects costing as much as $1.5 million.[24] By the time all of the renovations were completed, the company had invested over $1 billion in the belief that "nicer-looking stores attract more business."

At the same time, Skinner sent chefs at McDonald's back to the drawing board to research new menu possibilities more in line with current health trends. The company had grown lax in its product development efforts, as evidenced by its $100 million Arch Deluxe mistake and other failures such as the McPizza, McHotDog, and McSalad Shaker.[25] McDonald's also lagged significantly behind its competitors in purging trans fats from its recipes.[26] Under Skinner, the company took the time to conduct extensive market research and developed a new passion for numbers. Potential new menu items had to pass a series of tests before they could move on to the next stage of development, based on an analysis of their sales, margins, costs, and time and ease of production.[27] This more rigorous approach led to the development of the "Oven Selects" sandwiches, a southern-style fried-chicken biscuit for breakfast, and of course, the McCafé line of coffees, smoothies, and other beverages.[28, 29]

The other half of the equation involved cost cutting by improving operational efficiency. Adamant that McDonald's would not make its burgers smaller just to save money, Skinner directed his executives to find more creative ways to increase margins. So, the company cut travel, held meetings at Hamburger University instead of expensive hotels, and increased personal usage fees on company vehicles. Meanwhile, the company continued to invest in time- and cost-saving technologies such as more efficient drive-through windows and computers.

By the time Don Thompson became CEO in 2012, most of the low-hanging fruit had already been plucked. Thompson graduated from Purdue University in 1984 with a degree in electrical engineering, and he was recruited to McDonald's four years later to design robotics for food transport and control circuits for cooking equipment. He soon changed his career focus from engineering to operations, working a wide range of jobs from fry cook to regional manager to understand the company's day-to-day activities.[30] Ascending to serve as Skinner's COO, Thompson spearheaded the successful McCafé campaign and seemed a natural selection to produce the next "McHit."[31] McDonald's struggled with weakening sales under Thompson's reign (see **Exhibit 2**) despite his efforts to optimize the menu, improve the customer experience, and make McDonald's more accessible to a broader market base.

Unable to produce the desired turnaround, Thompson retired in January 2015 to make room for new leadership.[32]

Hailing from the U.K., Steve Easterbrook was appointed as the CEO of McDonald's on March 1, 2015.

Easterbrook came to the top spot having turned around the McDonald's UK and European operations, which were now among the best performing in the company. He had worked his way up to McDonald's top brand officer by 2010, then left to head two British restaurants (PizzaExpress Ltd. and Wagamama Ltd.), before returning to his former position in June 2013. Under Thompson, he subsequently assumed responsibility for corporate strategy and the restaurant solutions group. While some questioned whether another inside succession could provide the shake-up that McDonald's needed, others argued that Easterbrook had the right expertise in branding and media and willingness to focus on the menu, the areas with the greatest need of improvement.[33] In his first press conference as CEO, Easterbrook had presented himself as an "internal activist" who was "comfortable making the big decisions that were required to get the turnaround going."[34] Now it was time to deliver on his promise to turn McDonald's into a "modern, progressive burger company."[35] **Exhibit 3** shows McDonald's' revenues by regions and market segments, (2013–2016).

Given his low-key profile, observers were surprised when Steve Easterbrook also announced that McDonald's would move its headquarters from Oak Brook, where it resided in a custom-built campus for some four decades, to Chicago's West Town neighborhood in 2018. Easterbrook is moving the McDonald's HQ to this swanky area of Chicago full of restaurants and bars, to be closer to the millennials they want as employees and as customers.[36]

By 2017, McDonald's was pursuing an aggressive technology upgrade to allow Starbucks-like interactivity to both smooth out operational waiting times and improve the customer experience. Franchisees were hesitant to invest the hundreds of thousands of dollars required to upgrade with stand-alone kiosks, but they were bound by stringent franchising contracts and pressure from corporate headquarters.

Trends in the Quick-Service Restaurant Industry

The U.S. quick-service restaurant industry is expected to reach $224 billion in 2020 (see **Exhibit 4**). Yet despite expectations for some growth, several environmental trends suggest challenges ahead.

ECONOMIC TRENDS

The U.S. economy continues to bounce back from the 2008–2010 great economic recession. The unemployment rate has been cut in half from its 2009 peak at 10.0 percent to just 5.1 percent in 2015, and per capita real disposable income is near record highs.[37] These data present both good and bad news for the fast food industry. On the one hand, more customers are working and have more money to eat out; on the other hand, customers with more disposable income are likely to "trade up" to higher quality and higher priced food options. Recent data on dining trends bear this out: For the first time ever, American spending on dining out exceeded grocery sales in April 2015. A closer look, however, reveals key differences among market segments. Older consumers (51 to 69 year olds) reported spending more on groceries and less on restaurant dining compared to recent years. The overall upward trend is due to the vast number of millennials who view dining out as a social event and are more willing to pay for food outside of home. According to the Restaurant Association, millennials tend to favor quick service, deli, and pizza joints over more traditional casual and high-end dining; ethnic foods are also viewed as new and interesting.[38]

Since the end of 2016, the economy has picked up further with the U.S. stock markets reaching all-time highs in 2017. By fall of 2017, the U.S. unemployment rate had further declined to 4.3 percent. Around four percent unemployment is a level that many economists consider "structural unemployment," under which unemployment is unlikely to fall unless more structural factors in the economy such as a mismatch between open jobs and skills of labor force are brought into balance.[39]

HEALTH CONCERNS

The McKinsey Global Institute estimates that the global obesity epidemic costs $2 trillion per year in health care costs, a figure roughly equivalent to Russia's gross domestic product.[40] Approximately one-third of the world population (~ 2.1 billion people) is considered overweight, making obesity the third largest human-caused economic burden. Obesity-related health care expenses in the United States total $663 billion annually.[41] Beef still comprises the highest proportion (58 percent) of meat consumed in the United States, but health-conscious consumers are increasingly shifting toward poultry and other lean meats.[42] In 2010, to support healthier food choices, The Patient Protection and Affordable Care Act stipulated that calorie counts must be displayed on all food service menus of chains with at least 20 units and that restaurants must provide additional nutritional information upon request. These trends place considerable pressure on a fast food company that depends on hamburgers for the main portion of its income. McDonald's has been sued (unsuccessfully) for making its customers fat and was featured in an unflattering documentary *(Super Size Me)*, in which Morgan Spurlock grew increasingly ill and gained 25 pounds after eating only McDonald's food for one month.[43]

Meanwhile, concerns over the increase in antibiotic-resistant bacteria have led to calls for the elimination of subtherapeutic antibiotic use in meat animals. Though banned in the EU and Canada, the United States still permits farmers to administer small doses of antibiotics to livestock to increase weight gain (a three percent increase).

McDonald's recently followed in the footsteps of several of its competitors and announced its intent to stop selling chicken products from birds treated with antibiotics important to human health (non-human antibiotics are still permitted). Given that McDonald's claims to be the largest restaurant seller of chicken in the United States, this move is likely to reverberate throughout the poultry industry. Changes in cattle production are likely to move much more slowly due to higher beef prices, the longer life span of cattle, and the fragmented nature of the beef industry.[44]

Moreover, besides ending the use of antibiotics in the chickens used, Easterbrook also decided to remove high-fructose corn syrup from McDonald's hamburger buns. He also laid out a 10-year plan to only use suppliers that keep chickens cage free. These moves could be potentially transformative for McDonald's, as chicken and eggs account now for roughly 50 percent of the menu items.[45] One reason for the high percentage level is Easterbrook's early decision to offer all-day breakfast, which was well-received in the U.S. market.

INCREASING SUPPLY COSTS

Healthier menu items mean increased supply costs for restaurants, even as customers remain price sensitive. Beef prices began to rise sharply in late 2012 due to a severe drought in Texas. Without rain, farmers were forced to turn to more expensive forms of feed such as hay and corn, to ship cattle to greener pastures in the north, or to cull their herds through sales or sending heifers to the butcher instead of breeding them. By January 2014, the number of cattle in the United States totaled just 87.7 million, the lowest since 1951. Even though the Texas drought ended in the spring of 2015, it takes years to rebuild a herd, and California (the nation's fourth largest cattle-producing state) experienced extreme drought conditions during 2015. At the same time, demand for hamburger meat has soared due to high beef prices ("hamburger is the new steak") and the popularity of new burger chains like Five Guys and Shake Shack.[46]

Drought conditions in recent years have also made it more expensive to raise agricultural products. Not only is corn one of the main products used to feed both cattle and chickens, but corn oil, meal, and other by-products are a significant component of many grocery items. Soybean meal is a main ingredient of animal feed, while the oil is used in cooking, salad dressing, mayonnaise, and baked goods. Wheat, of course, is the main ingredient in hamburger buns. In addition, egg prices soared in 2015 due to an outbreak of the avian flu (broilers or chickens raised for meat were not affected and remain in good supply). The resulting price increases for supplies ranging from bread to eggs to meat are squeezing already tight operating margins.

Current Competitors

Traditionally, main competition for McDonald's has come from other quick-service restaurants such as Wendy's, Burger King, and Yum! Brands' Taco Bell. McDonald's is roughly twice the size of its next largest global competitor (all three Yum! Brands combined), but has slightly fewer outlets.[47] It controls almost half of the U.S. hamburger market, which is more than three times larger than the market share held by either Wendy's or Burger King.

BURGER KING

On August 26, 2014, Burger King merged with the Canadian restaurant chain Tim Hortons to form the world's third-largest quick-service restaurant chain (second largest in the United States). The combined company has annual sales of $23 billion, with over 18,000 restaurants in approximately 100 countries. Because it is headquartered in Canada, the new parent firm (Restaurant Brands International, or RBI), benefits from a significantly lower corporate tax rate than its American competitors.[48] The firm denies that tax inversion was the primary motive for the merger, but tax savings could total $1.2 billion through 2018. The private equity firm 3G Capital, which took Burger King private in 2010, continues to hold 51 percent of the shares.

Changes made by the new ownership appear to be positive, as the company has recently out-performed both McDonald's and Wendy's. Analysts attribute Burger King's success to its simplicity: adding sauces, cheese, or bacon to its core burger line to create new menu items from the same list of ingredients. Coupled with successful limited time offers and attractive promotions, Burger King has been able to innovate without slowing service.[49]

In 2015, Burger King launched an aggressive attack against its larger competitor, using strategic price increases to cover the costs of aggressive promotions on popular products such as chicken nuggets. The company has gained further recognition with clever advertising, such as its letter to McDonald's offering a temporary ceasefire in the burger wars, suggesting that they jointly make "McWhoppers" for international peace day, with all proceeds going to the Peace One Day organization. McDonald's spurned the proposal, earning headlines accusing them of throwing "their 'love-themed' brand idea out the window" and choosing "pride over peace."

In 2017, revenues for Burger King's parent company, Restaurant Brands International, were $4.3 billion. Burger King contributes most of sales. Besides Tim Hortons and Burger King, RBI also acquired Popeyes in 2017 for $1.6 billion.[50]

WENDY'S

Wendy's is the third largest U.S. burger chain, with more than 6,500 locations in 28 countries. Wendy's strives to differentiate itself as "a cut above" its competitors, with higher-quality food that is made fresh-to-order. It successfully employs a "barbell" approach to products and pricing, luring cost-sensitive customers in with value-based burgers while offering higher-end, premium items like the Pretzel Bacon Cheeseburger or Bacon Portabella Melt to attract more affluent clientele. Analysts offer several reasons as to why Wendy's has succeeded with this strategy while McDonald's has struggled. Not only is it easier for the smaller chain to implement short-term menu changes, but it has long specialized in custom-building sandwiches without compromising quick service. Wendy's also seems to have a better pulse on its customers and bets big on just a few hit products, such as its pretzel buns.[51]

Wendy's continues to invest in long-term brand development by redesigning its stores, offering an expanded menu including breakfast, and a new advertising campaign. At a price tag of up to $700,000 per store, the remodeling cost the company $225 million in capital expenditures in 2012 alone, the first year of its renovation program. The good news for Wendy's is that the physical upgrades appear to be associated with an increase in same-store sales of five to 25 percent (i.e., the stores are generally recouping their expenses). Recent additions to Wendy's menu such as its sea-salt French fries, a new line of salads, and organic Honest Tea, have proven quite popular, helping to generate several consecutive quarterly sales increases for the corporation. At the same time, Wendy's continues to cut costs by refranchising company-owned stores, with the goal of decreasing its ownership from 15 to five percent of the total.

In 2017, Wendy's revenues were $1.3 billion, down from $2.5 billion in 2013.

TACO BELL

Taco Bell (a division of Yum! Brands) is the most widely recognized Tex-Mex option in the quick-service restaurant category, with approximately 6,000 restaurants (80 percent of which are franchises) in the United States. After a string of food contamination and quality issues from 2006 through 2011, the company started to rebound in 2012. Taco Bell's leadership credits its comeback to the successful introduction of its new, healthier Cantina Bell product line and the popular "Doritos Locos Tacos."

Taco Bell tries to launch eight to ten new items per year, knowing that the sales bump from major hits like Locos Tacos levels off within about two years. It rolled out breakfast nationwide in 2014 and continues to expand its offerings; breakfast now constitutes seven percent of sales or $70,000 to $120,000 per store annually. In 2015, Taco Bell released its Naked Crispy Chicken Taco (which uses batter-fried chicken as the shell) in California and a new urban-store format that serves alcoholic beverages in Chicago.

To appeal to millennials, the company has developed a food-ordering app (Live Mas) and is testing a new home delivery service in conjunction with Kentucky Fried Chicken. Managers expected the app to speed up orders and decrease errors, but they were pleasantly surprised to discover that customers spent more than $10 average per online order, a 20 percent increase over in-person transaction. Orders are not filled until the customer gets within 500 feet of the restaurant and specifies whether they plan to come in or drive through to pick up their food. The app has already been downloaded more than three million times. The chain plans to double its revenues from $7 billion to $14 billion and grow to 8,000 U.S. locations over the next 10 years.

SUBWAY

A different sort of quick-service competitor that challenges McDonald's' dominance is Subway. Known for its healthier menu items and fresh ingredients, Subway exceeds McDonald's in the number of total restaurants (45,000 globally, including 27,000 in the United States). The chain has become a popular lunchtime destination for many Americans who value convenience but do not want to compromise their health.

Although Subway continues to open new restaurants around the world, the former quick-serve superstar is also facing significant challenges. Sales dropped by 3.3 percent to $11.9 billion in 2014 for the first time ever, the worst drop among fast food chains; annual sales per store decreased from $490,000 to $475,000. Subway is no longer the cool "new kid" on the block compared to upstarts like Jersey Mike's or Firehouse Subs. While Subway remained content with being a "healthy" option, competitors started to offer organic, GMO-free, and transparently sourced ingredients. Insiders say the company has lacked strong leadership ever since its founder, Fred DeLuca, was diagnosed with leukemia in 2013. Before dying in 2015, DeLuca promoted his sister, Suzanne Greco, to president and CEO. By the fall of 2017, Suzanne Greco still holds both jobs. In the same year, Subway's sales reached $17 billion.

FAST CASUAL

Boundaries between quick-service and other restaurant segments have become increasingly blurred. Fast-casual restaurants provide high-quality food without table service, in a distinctive atmosphere, at prices that are "low enough." Some observers describe fast casual restaurants as distinguished by the 10 Fs: Full view preparation of food; Food quality; Fine ingredients; "Fitter" wholesome food; Fresh; First-rate décor; Fair price; Fast service; Friendly employees; and Flexible offerings.[52] Due to this successful combination of higher quality and affordable prices, the fast-casual segment is one of the few areas in the restaurant industry that is experiencing steady growth.[53] Combined fast-casual sales increased by double digits in the last few years, and is expected to continue into the near future. Even traditional sit-down restaurants are looking at ways to move into the fast-casual arena by offering selected scaled-down dishes that appeal to value-seeking diners.

A sub-segment of the fast-casual restaurant industry is the premium burger segment, which grew 10 times faster than traditional fast food chains from 2008 through 2013.[54] Customers have been flocking to burger chains such as Five Guys, In-N-Out Burger, Shake Shack, Smashburger, and Fatburger for higher-priced, higher-quality burgers, while fast food restaurants such as McDonald's, Burger King, and Wendy's have scrambled to counter with their own premium offerings. Customers have been known to wait in line for nearly an hour to get a Shake Shack burger and fries; the company's shares proved to be just as popular in its January 2015 IPO, more than doubling in price from $21 to $45.90 on the first day of trading. In the meantime, investors cooled on Shake Shack, with its market capitalization falling from $3.3 billion in the spring of 2015 to a mere $1.1 billion in the fall of 2017. Revenues were $316 million in same year.

But much like the Arch Deluxe in the 1990s, McDonald's more recent efforts to compete in the premium segment have fallen flat. Customers could not justify paying $4 to $5 for a one-third pound Angus burger when there were sandwiches on the McDonald's Dollar Menu for much less. The company discontinued the Angus Deluxe product line in 2013 after just four years.[55]

Other fast-casual restaurants such as Chipotle Mexican Grill, Panera Bread, and more recently even Starbucks, have taken away customers from McDonald's.

COFFEE

McDonald's expanding into specialty coffee drinks with the McCafé line means that it also competes with more traditional coffee shops such as Starbucks and Dunkin' Donuts. Starbucks answered the introduction of McCafé by distributing its Seattle's Best brand to other quick-service restaurants such as Burger King and Subway. It purchased La Boulange Bakery in 2012 to expand its food offerings, which are now available in more than 2,500 stores. In total, Starbucks has over 25,000 stores, and garnered revenues of over $22 billion in 2017.

Attempting to drive more store traffic in outside the morning hours where customers need their daily caffeine shot, Starbucks has added baked goods, sandwiches, and other food items to its menu. To get more customers into its stores in the late afternoon and early evening—traditionally its slowest time—Starbucks stores now offer items such as vegetables, flatbread pizza, plates of cheese, and desserts. It even introduced alcoholic beverages such as wine and beer, available after 4 p.m., as part of an "Evenings" program. Starbucks also continues its efforts to find new levels of luxury offerings catering to higher end customers within its existing customer base. Online and in stores it produces limited-run exclusive batches of varietal coffees for home use, at high price points. Some stores also offer individually brewed cups of the same higher-priced roasts. Since 2014 Starbucks has created something called a Starbucks Reserve Roastery and Tasting Room. The first of super high-end stores appeared in Starbucks' home, in Seattle, with additional locations planned domestically and around the world.

Dunkin Donuts, on the lower price point of the spectrum, plans to triple its presence to 15,000 shops and is likewise expanding its warm breakfast options to compete more effectively.[56] Dunkin' Donuts, which has served coffee for more than 60 years, made a failed bid to trademark its brew as the "Best Coffee in America." As coffee shops sell more food and restaurants dispense specialty coffees, competition between these once distinct market segments is becoming more intense.

Target Market

Market research indicates that the typical American dines out about five times per week. One of the main reasons so many quick-service restaurants are focusing on new breakfast items is that the early morning meal is the least saturated. For every restaurant breakfast, the NPD Group estimates that the average American consumes 2.5 lunches and almost two dinners outside the home. Around 11 to 12 percent of these meals are eaten at McDonald's.[57]

A quick breakdown of a typical McDonald's franchise in a middle-class suburb of 25,000 residents provides additional market insight. Roughly one out of 16 or 1,500 people in town visit the local McDonald's over the course of a given day. Breakfast accounts for the largest proportion (30 percent) of sales, followed by lunch (24 percent); afternoon, dinnertime, and late night/early morning each account for another 15 to 16 percent of sales. The noon lunch hour is the busiest and most profitable time of day, bringing in $200,000 in revenues. Annually, the average franchise can be expected to bring in about $1.7 million in sales, with an operating profit of around $150,000.

The three main target market segments McDonald's are mothers, children, and young adults.[58] Moms view McDonald's as a quick, easy, and affordable meal for families on the go, and they usually are the ones who bring the children. But with 17 percent of U.S. youth considered obese, fast food chains find themselves in an awkward position when marketing directly to children. In response to parental demands for healthier kid meal options, McDonald's reduced its Happy Meal calorie count by 20 percent by adding apples and halving the amount of french fries. McDonald's has reduced the sodium content of its food by 15 percent, and plans to make further reductions in calories, sugars, saturated fats, and portion sizes by 2020.[59] Even this was not enough for a nine-year-old girl who publicly took then-CEO Thompson to task at a shareholders' meeting, accusing the company of tricking kids into eating junk food by using toys and cartoon characters.[60] Other chains, such as Jack in the Box, have opted to eliminate toys from their kids' meals, while Taco Bell has dropped its children's menu altogether.

The key demographic group for most fast food restaurants is comprised of young, single professionals who earn above-average incomes. These so-called "heavy users" frequent a given chain twice or more per week, providing a steady source of sales and profit. A recent study, however, indicated that McDonald's was not even in the top 10 of the 18-to-32-year-old age group's favorite restaurants. Instead, millennials are more likely to eat at fast-casual restaurants that emphasize ingredient quality and demonstrate an awareness of social issues like environmental sustainability. Transparency is also important to young adults. Restaurants such as Chipotle and Panera Bread are known for demonstrating openness about their food sourcing and preparation, whereas McDonald's has been plagued by perceived deceptions. As an example, vegetarians raised an uproar once it was discovered that McDonald's had continued to use a small amount of beef tallow as flavoring when cooking its french fries. McDonald's was also forced to discontinue making burgers out of "boneless lean beef trimmings" mixed with ammonium hydroxide,after Jamie Oliver exposed the company's use of "pink slime" on national television.[61]

McDonald's Corporation

Current Challenges

MENU

In 2017, McDonald's operated a total 37,000 restaurants globally, with 14,300 of them in the U.S. One of Easterbrook's first major moves was to propose all-day breakfast in all U.S. restaurants, the company's biggest initiative in six years. Testing started almost immediately after he took office, with a rollout in fall 2015.

Consumers had long been asking for this change, but the company resisted because stores use the same equipment to cook both breakfast and lunch. All kitchens are now equipped with separate grills for cooking eggs and burgers, rolling carts and utensils to use just with eggs (to prevent contamination), and new toasters so that they can prepare both buns and muffins at the same time (they toast at different temperatures). The estimated cost for retrofitting each kitchen is $500 to $5,000, depending on existing equipment. To make things a bit more manageable, the all-day breakfast menu will be restricted to a few popular items such as sausage burritos, hot cakes, Egg McMuffins, or biscuit sandwiches. Breakfast items will be made continuously during peak morning hours, but cooked-to-order during slower parts of the day. An internal McDonald's presentation projected that extending breakfast hours could increase sales by 2.5 percent per year.[62]

Another way that Easterbrook is giving customers more choice in what they eat is by giving franchises more freedom to offer locally relevant menu items. For example, chorizo burritos are more popular in Texas and the Midwest, while mozzarella sticks sell better in New York and New Jersey. Local restaurant operators can choose items from the company's global pipeline and adjust them as needed to suit local tastes. Managers will also be granted more freedom to run their own promotions to increase store traffic.[63]

As a direct competitive response to the "better burger chains," McDonald's is experimenting with "Build Your Own" tablets where customers design their own sandwich from over 30 choices of meats, toppings, and buns. They can only be ordered from inside the restaurant, cost $1.50 more than a Big Mac, and take seven to eight minutes to prepare because the meat is cooked fresh. It will cost each franchisee approximately $100,000 per store to install the new system and stock the required ingredients. This presents an interesting conundrum for a quick-serve restaurant that generates roughly two-thirds of its revenue from drive-through customers.[64]

To free up space for these new offerings, the company plans to phase out underperforming features such as the snack wrap and reduce the number of extra value meals. Still, the McDonald's menu has swollen to over 120 items, many of which require specialized equipment and take more time to prepare. That represents a 75 percent increase from 2004 and is considerably more than the 33-item menu from 1990. While a greater variety of menu options helps to draw new customers into stores, too many items slow down the order fulfilment process, increasing employee stress and customer frustrations. The average service time for a McDonald's drive-through has slowed to 189.49 seconds, lagging rival Wendy's average by almost a minute.[65] Complaints about speed of service have "increased significantly" in recent years, with the McDonald's service experience described as "chaotic."[66]

PRODUCT QUALITY

Another item on Easterbrook's to-do list is to improve public perceptions of the McDonald's brand. The size of McDonald's made it a convenient target, and more than a decade of negative press including the 2001 book, *Fast Food Nation*, the 2004 documentary *Super Size Me*, and Jamie Oliver's 2012 "pink slime" exposé has taken its toll.[67] In July 2014, the Big Mac earned the dubious distinction of being America's worst hamburger, placing last out of 21 in a study by Consumer Reports.[68] McDonald's also ranked lowest among peers in the 2015 American Customer Satisfaction Index. Fast food restaurants overall dropped 3.8 percent, but McDonald's fell by six percent from 2014, holding firm in the last spot.[69]

Easterbrook has declared improving food quality as one of his top priorities. In addition to curtailing antibiotic use in its U.S. chicken supply, McDonald's is now selling dairy products from growth-hormone-free cattle. The company has also pledged to examine its product ingredients and review its food preparation procedures. Its goal is to become more "culinary inspired" and to simplify food labels by reducing the number of preservatives.[70] There are still 19 ingredients in the French fries McDonald's serves in the United States, compared to just five in Great Britain.[71]

Easterbrook simultaneously counterattacks McDonald's' naysayers with a media campaign highlighting positive news about the company's food and workers. The company has launched a video series entitled "Our Food, Your Questions," demonstrating how McDonald's food items are made. The company reports that it has already responded to 40,000 questions and that the increased transparency has been well received. In June 2015, Easterbrook hired two external candidates to take over the company's media affairs. He tapped Robert Gibbs, former White House Press Secretary under President Obama, to serve as executive vice president and global chief communications officer, and Silvia Lagnado, previously with Bacardi Ltd., to serve as head of global marketing.[72]

APPEALING TO MILLENNIALS

One of the more perplexing problems that Easterbrook faces is how to increase its appeal to millennials. Between 2011 and 2014, 19- to 21-year olds increased their monthly visits to fast-casual restaurants by 2.3 percent, while their trips to McDonald's decreased by 12.9 percent. Customers aged 22 to 37 increased their fast-casual outings by 5.2 percent over the same time period, while visits to McDonald's stayed flat.[73] They are consistently choosing "fresh and healthy" over "fast and convenient" and "McDonald's is having trouble convincing them it can be both."[74]

Thus far, Easterbrook's main response has been to reach out through digitization. In his words, millennials "want to buy into a brand not just from it....What we've got to do is find interesting and engaging ways to share that information with [them], not old-fashioned corporate lecturing."[75] He hired a former Google executive to lead McDonald's "Experience of the Future," which includes an improved social media presence, development of a smartphone app, and testing of mobile payment systems.[76]

LABOR

McDonald's has serious staffing issues that need to be addressed if it is to improve customer loyalty. An internal report that found its way to the media showed that one out of every five customer complaints was about "rude or unprofessional employees."[77] According to a national survey of quick-service restaurants, McDonald's ranks next to last in "friendliness," beating only Burger King. Part of the problem is that too many restaurants are understaffed during peak breakfast and lunch hours. It is hard to be friendly while work piles up and customers grow increasingly irritated at how long it takes to place and get their orders. The annual turnover rate in the fast food industry is 60 percent, as frustrated workers seek to move on to less stressful and higher-paying jobs.[78]

It is too soon to tell whether McDonald's pledge to raise pay to at least $1 more per hour than the local minimum wage will be enough to attract and retain motivated workers. The company also granted employees the ability to accrue up to five days of paid vacation annually after one year of employment. However, this new HR policy applies only to the 90,000 employees of company-owned stores, and risks upsetting franchisees who are likely to feel pressured to match corporate's offer without equivalent financial resources. Meanwhile, activists continue to lobby for an even larger pay raise (a $15-per-hour minimum) as well as the right to unionize without retaliation. To force McDonald's to the negotiating table, the National Labor Relations Board's (NLRB) general counsel has filed a suit claiming that the company has enough control over franchise operations to be considered a joint employer. As of fall 2017, the case is still ongoing.

INTERNATIONAL MARKETS

Like many U.S.-based global companies, McDonald's has most of its net-new growth from international markets. The secular story that "consumers in emerging markets eat out more often as their income increases" is still intact. Furthermore, BMO Capital Markets, an investment bank, notes that the quick-service-restaurant (QSR) hamburger sales have an annual growth rate of 12–13 percent in China, and 21–22 percent in Russia, for the last 10 years.[79]

In the fourth quarter of 2016, U.S. same-store sales dropped by five percent, but that was better than estimates. In contrast, during the same quarter, international growth was only 1.3 percent and the Wall Street analysts were notably "gloomy" at the results.[80] When McDonald's reports their financial and operational results, they further divvy up international results into "international," "high growth," and "foundational" markets (**Exhibit 3**). In the end, non-US growth matters.

McDonald's has taken a differing approach to these markets. In China and Hong Kong, the company recently sold an 80 percent stake in their 1,750 restaurants to Citic (state-owned investment group) and the U.S. private equity firm, Carlyle. They are currently looking for these partners to open an additional 1,500 stores in China, Hong Kong, and Korea.[81]

Going Forward

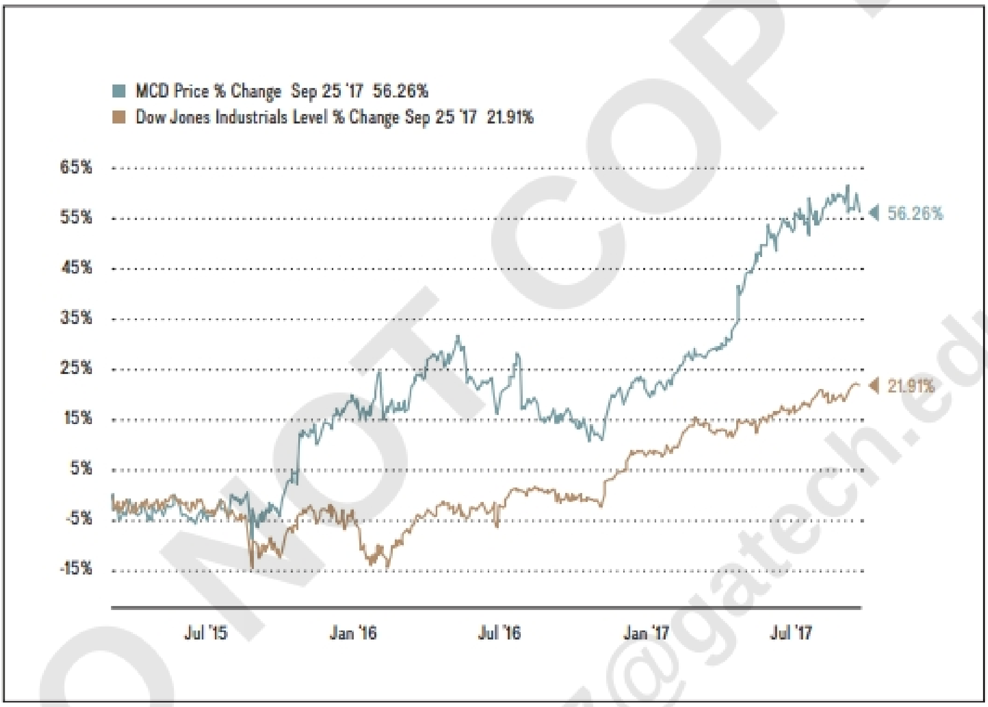
The host of issues facing McDonald's and its CEO Mr. Easterbrook is daunting. The company is amid its most serious identity crisis to date, and it desperately needs to define a clear vision of what it wants to be and a plan for how to get there. In trying to be all things to all people, it has ceded ground on every front to its competitors. Fast-casual restaurants are winning on taste and image, but the only way to catch them seems to be to sacrifice speed, which at least used to be one of the McDonald's core competencies. Millennials want higher product quality (and are willing to pay higher prices), but the company can ill afford to alienate its value-driven customer base. Menu variety brings a wide range of consumers through its doorways, but the added complexity comes with increased costs and service delays. And after all this time, 30 percent of the company's sales still derive from just five main items: Big Macs, hamburgers, cheeseburgers, McNuggets, and fries.[82] Other fast food restaurants are not only faster, but (according to the polls) also have better food. Instilling "stronger financial discipline, faster decision-making, and hard-edged accountability"[83] are good first steps, but none of these actions matter if Easterbrook fails to carve out a viable strategy for McDonald's in the 21st century.

In 2016, with the release of a feature film, *Founder*, staring Michael Keaton as Ray Kroc, there has been a renewed interest in the McDonald's story. Although over 60 years of history separate Ray Kroc and Steve Easterbrook, the key challenges remain largely the same:

- How to provide a product that balances quality, speed, and affordability?
- How to innovate the menu without creating unnecessary menu scope creep?
- How to respond to competitive threats without losing the company's core identity?
- How to prevent complacency, in spite of many years of relative success?

In a recent talk at the Chief Executives Club, at Boston College, Easterbrook said, "We don't need to be a different McDonald's, we just need to be a better McDonald's."[84]

EXHIBIT 1 McDonald's (Normalized) Stock Performance Vis-à-Vis S&P 500 Index Since Steve Easterbrook Was Appointed CEO, March 1, 2015–September 25, 2017



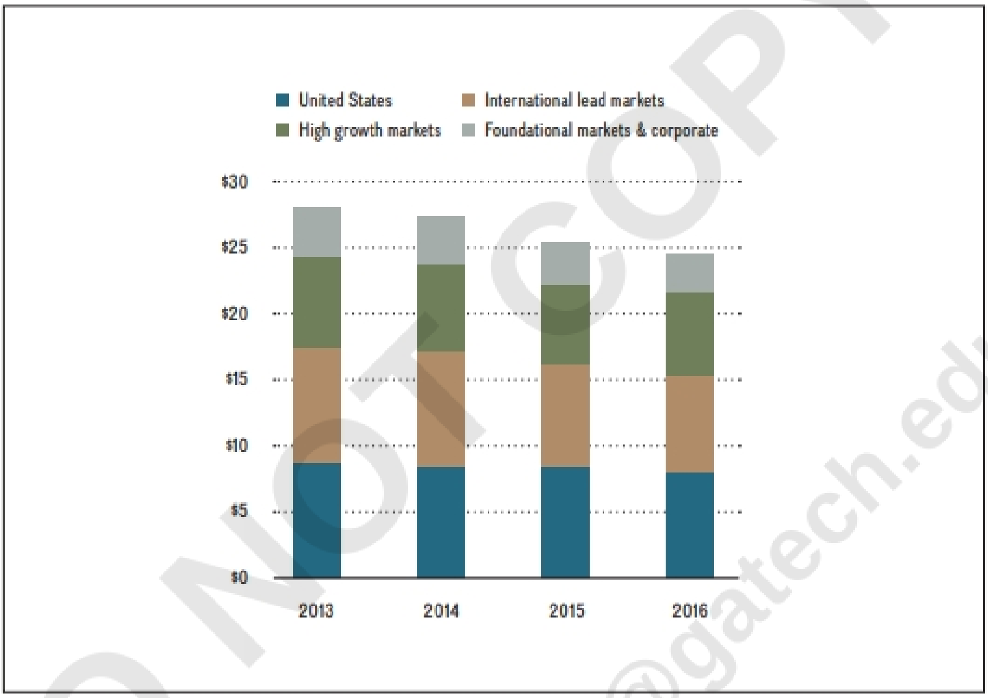
Source: Depiction of publicly available data.

EXHIBIT 2 McDonald's Financial Data ($ millions, except EPS data)

Fiscal Year	2012	2013	2014	2015	2016
Cash and short-term investments	2,336	2,799	2,078	7,686	1,223
Receivables (total)	1,375	1,320	1,214	1,299	1,474
Inventories (total)	122	124	110	100	59
Property, plant, and equipment (net total)	24,677	25,747	24,558	23,118	21,258
Depreciation, depletion, and amortization (accumulated)	13,814	14,608	14,569	14,575	13,186
Assets (total)	35,387	36,626	34,281	37,939	31,024
Accounts payable (trade)	1,142	1,086	860	875	756
Long-term debt	13,633	14,130	14,990	24,122	25,879
Liabilities (total)	20,093	20,617	21,428	30,851	33,228
Stockholders' equity (total)	15,294	16,010	12,853	7,088	-2,204
Sales (net)	27,567	28,106	27,441	25,413	24,622
Cost of goods sold	15,349	15,704	15,446	14,186	13,027
Selling, general, and administrative expense	2,455	2,386	2,488	2,434	2,385
Income taxes	2,614	2,619	2,614	2,026	2,180
Income before extraordinary items	5,465	5,586	4,758	4,529	4,687
Net income (loss)	5,465	5,586	4,758	4,529	4,687
Earnings per share (basic) excluding extraordinary items	5.41	5.59	4.85	4.82	5.49
Earnings per share (diluted) excluding extraordinary items	5.36	5.55	4.82	4.80	5.44

Source: McDonald's Annual Reports (various years).

EXHIBIT 3 McDonald's Revenues by Regions and Market Segments, 2013-2016 *, **



* includes sales for both, franchised and company-owned restaurants.

** International lead markets: Established markets, including Australia, Canada, France, Germany, the U.K., among others.

High growth markets: markets with relatively higher restaurant expansion and franchising potential, including China, Italy, Korea, Poland, Russia, Spain, Switzerland, the Netherlands, among others.

Foundational markets & corporate: Remaining markets, each operating largely under the franchised model, including corporate activities.

Source: Depiction of data in McDonald's Annual Reports (various years).