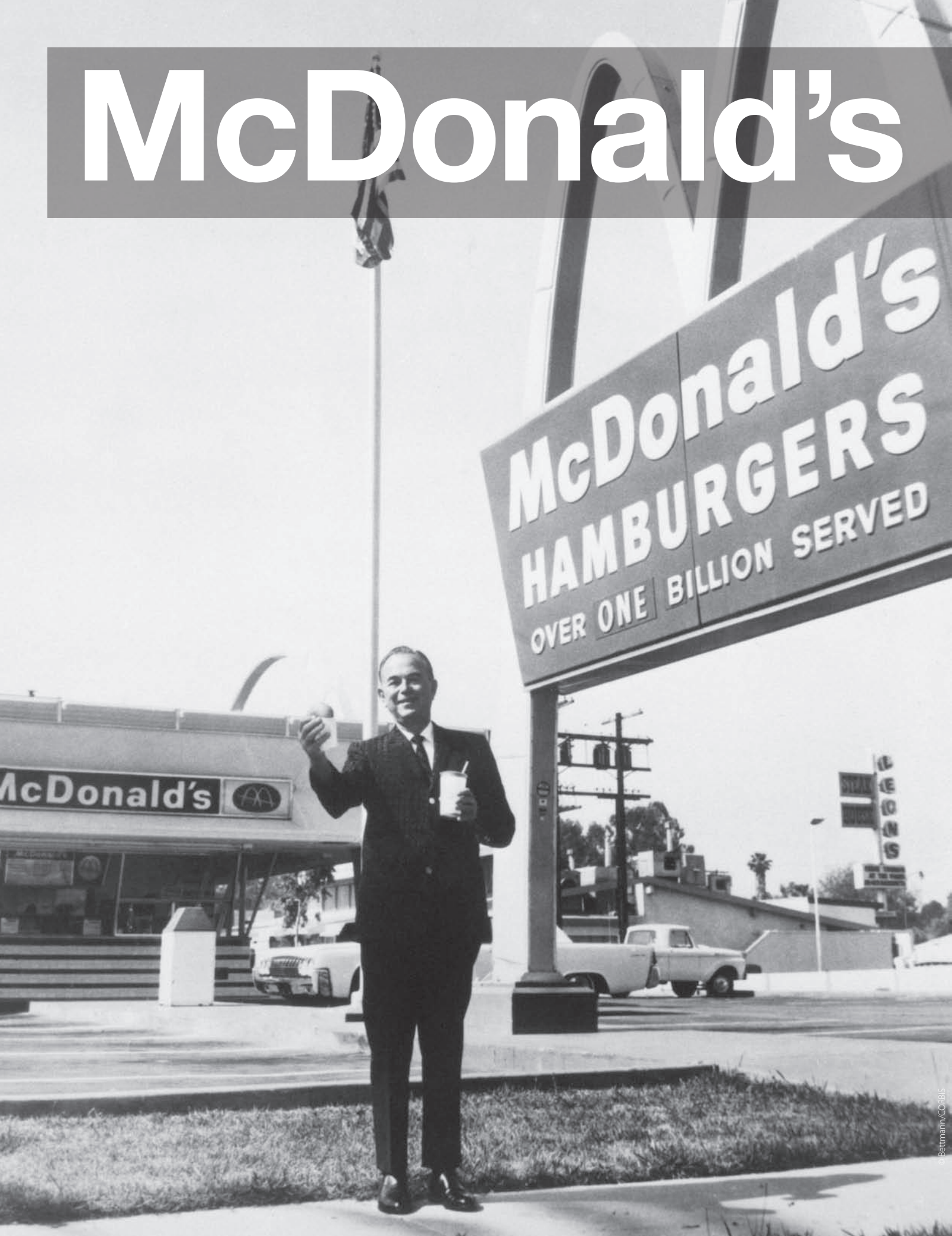


McDonald's



and the New Franchising Paradigm

By Steven Mark Adelson

IF YOU WERE TO ASK for the name of world's largest real estate developer and property management firm, you may be surprised by the answer: McDonald's. Aside from being the largest purveyor of food in the world, the company controls the real estate in 33,000 restaurant locations in 119 countries and territories.

The McDonald Brothers

The founders of McDonald's—Richard and Maurice McDonald—did not start out by selling hamburgers.

Natives of New Hampshire, the brothers moved to Los Angeles at the start of the Depression in the hopes of finding opportunity and a better life. By 1940, they relocated to San Bernardino, then a small bedroom community 55 miles east of Los Angeles, and with a \$5,000 loan from the Bank of America opened a drive-in with a menu consisting of 25 items, with slow-smoked barbecue as the featured item.

Located near a high school, their new place quickly became successful and soon employed 20 carhops. But by 1948, the McDonald brothers were thinking of selling for many reasons: dishes, glassware and silverware had to be replaced due to constant breakage and theft; turnover of both carhops and cooks were high; and wages consumed 35–40% of their gross income. But instead of selling the business outright, they experimented with something new.

The McDonald brothers wanted to implement a trend they noticed. A new concept called “self-service” was becoming popular with supermarkets and variety

stores, which offered lower prices through higher turnover and a minimum of employees. As Dick McDonald explained, “Our whole concept was based on speed, lower prices and volume. We were going after big, big volumes by lowering prices and by having the customer serve himself.”

The McDonald brothers examined their receipts over the prior three years and saw that hamburgers and cheeseburgers represented 80% of their sales. They therefore reduced the menu from 25 to nine items.

Out went the car hops, the indoor seating, the dishwasher and the barbecue pit. The plates, the flatware and the glasses were replaced with paper bags, paper cups and paper wrapping. To ensure that their new place didn't become a teenage hang-out, there were no jukeboxes, vending machines or pay phones.

The brothers redesigned the kitchen along the lines of a factory assembly line. They replaced their three-foot cast iron grill with two, custom-made stainless steel six-foot grills and added new equipment designed to meet the needs of food production on an industrial scale—a machine to quickly form hamburger patties, a condiment pump that would squirt just the right amount of ketchup or mustard with one squeeze and a “heat bar” under which to place the finished burgers.

And like a factory assembly line, a separate employee was trained to do each separate function. This meant one employee only had to be taught how to perform one repetitive task. Skilled and semi-skilled workers were no longer necessary—an unskilled teenager paid minimum wage would grill the hamburger, another would add condiments and wrap it, etc. Likewise, milk shakes and french fries were premade and placed into an “inventory” behind the counter until the order arrived.

Richard came up with a new design for a 1,600 square foot drive-in hamburger stand with a slightly cantilever roof where

he placed on both sides a 30-foot parabolic golden arch to be lit by neon at night.

With the new system, customers would have to walk up to the service window and place their order, and they would receive it in less than 60 seconds.

The new operation was so efficient that labor costs were slashed to 17% of gross income, allowing the brothers to price their hamburgers at 15¢, roughly half of what everyone else was charging.

After their regular customers got used to the new self-service format business boomed; during peak serving times it was not uncommon to see to lines 20 or more people deep. The format was so unique that their hamburger stand made the cover of the July 1952 issue of *American Restaurant* magazine with the headline “One Million Hamburgers and 160 Tons of French Fries a Year.”¹

Soon the brothers were making \$350,000 per year and splitting \$100,000 in profits (roughly \$1,000,000 today).


Then in 1954, they put in an order to the Prince Castle Sales Division in Oak Park, Illinois. They had no idea where that order would eventually lead.

Ray Kroc

Ray Kroc was born on October 5, 1902 in Chicago. In his sophomore year of high school he dropped out. Lying about his age (he was 15), he was sent to France during World War I to drive ambulances for the Red Cross.

After the war he drifted about until 1926 when he began a career as a traveling salesman for the Lily Cup Company (later called the Lily-Tulip Company in 1929). He sold paper cups to a variety of ice cream parlors, dairy bars, soda fountains, coffee shops, mom-and-pop dinettes and bars (cocktails and mixed drinks using liqueurs and ice cream were growing in popularity since the repeal of Prohibition),

Ray Kroc, founder and chairman of McDonald's Corporation, stands outside one of his franchises, holding a hamburger and a drink.



eventually establishing new accounts at Wrigley Field, Walgreen's (which often had a lunch counter in their drug stores) and in factory commissaries at Swift, Amour and US Steel.

Then in 1939 the Lily-Tulip Company turned down an offer to be the national distributor for a product that would dovetail the sales of paper cups.

Earl Prince, a mechanical engineer, invented a five-spindled mixer that he called The Multimixer. Kroc immediately saw the sales possibilities. At the age of 37 he acquired the marketing rights and formed the Prince Castle Sales Division. He went back to his old customers and sold them on the advantage of serving their customers faster and selling more drinks. With his knowledge and experience in sales and in the food service industry, Kroc was soon selling 9,000 units a year at \$150 each (over \$1,000 apiece today) and earning a salary of \$20,000 by the late 1940s.

Unfortunately, the good times did not last. By the early 1950s, sales were down to just 2,000 units. Competition from Hamilton Beach and the flight of city dwellers to the suburbs was killing off the corner drugstore with their lunch counters and soda fountains, representing two-thirds of his customers. The writing was on the wall—demand for the Multimixer was declining by the month. Ray Kroc was 52, an age where most men begin to think about retirement, and now he needed another way to make a living.

Then in 1954, he received an order that would change his life.

Reconnoitering

The order was for two more Multimixers for a small drive-in located in San Bernardino. The drive-in had already ordered eight recently, and now they needed two more? "What kind of an operation required a single restaurant to make 50 milkshakes at the same time?" Kroc flew out to California to see for himself.

In his memoir, *Grinding It Out*, Kroc describes the San Bernardino operation, noting the building's all-glass walls, the long lines, the spotless kitchen and the busy staff in their "spiffy white shirts and trousers, bustling around like ants at a picnic," serving hamburgers and fries to the working-class families that drove up. By lunchtime, 150 people had lined up. "Something was definitely happening here, I told myself this had to be the most amazing merchandising operation I had ever seen!"

Over the last 30 years Kroc observed the food service industry up close, from management organization, kitchen layout and food preparation. He made a great deal of mental notes as to what worked, what didn't and why. Mostly Kroc noticed that many independent food service operators had a "by-the-seat-of-your-pants" management style. Now here was something different: a small, streamlined establishment which had worked out standardized procedures to quickly deliver a uniform product at a low price.

The Offer

Kroc envisioned duplicating hundreds of this little stand throughout the country on a franchise basis. A conventional drive-in would cost about \$300,000 (in the mid-1950s), but a unit like this would run about \$40,000, plus an additional \$30,000 to acquire the half-acre store site. Although initially the McDonald brothers said "no" (they liked going home at night and dreaded all the traveling that running a franchising organization would entail), Kroc was persistent and eventually got them to sign him on as their exclusive franchising agent. Unfortunately, he was so anxious to become their agent that he found himself obligated to a horrendous financial arrangement.²

The arrangement he devised was as follows: the initial franchise fee would be \$950 and would be charged a 1.9% service fee assessed on their food sales, with 0.5%

paid to the McDonald brothers as a royalty. Kroc would keep the other 1.4% as a service fee to finance and run his office.

From the start, Kroc was determined that McDonald's not become the sort of operation he considered to be harmful to long-term growth. Specifically:

1. Demanding big, upfront fees for franchises. Kroc wanted individual owner/operators—people willing to place their life savings if need be—to invest in this hamburger stand, and thus be motivated to make *their* business a success. He refused to consider anyone who would be an absentee owner.
2. Requiring the franchisee to acquire all of their stock, supplies and equipment through the franchisor, who would then charge a hefty mark-up. This spurious relationship was a common practice and accepted under the banner "Quality Control," but in reality this was the primary means by which the franchisor made its money, along with collecting monthly royalties and whatever fees it could levy. Kroc would negotiate with purveyors to obtain the best price and pass along any savings.³
3. Kickbacks from suppliers to the franchisor were forbidden. Kroc believed this negated the promise of delivering a lower price through bulk purchases.
4. Also forbidden was the awarding of "Territorial Licenses." In this arrangement, an individual or corporation is awarded the exclusive right to conduct business within a specific geographic region, such as a state or a city. In exchange, the franchisor receives an upfront payment, which can run into the hundreds of thousands or millions of dollars. The Territorial Franchise holder would then scout for sites, construct his own units or recruit others to establish individual franchises and collect fees or royalties from them.
5. Often little thought was given to site selection, new product development or on-going management training beyond



The McDonald's Museum, a replica of the first corporate McDonald's restaurant, opened in Des Plaines, Illinois on April 15, 1955, after the franchise was acquired from founders Maurice and Richard McDonald.

the franchisee's initial course of instruction. Kroc believed these arrangements were detrimental to the success of the franchise and the system being created because:

- a. A conflict of interest existed between the franchisor and the owner of the franchise, deliberately designed to enrich franchisor.
- b. The franchisor made his money before the franchisee did, and always at his expense.

Kroc envisioned McDonald's as having a symbiotic relationship with each owner/operator — where headquarters was there to support, and not exploit, the franchisee. As Kroc once explained it, "You're in business for yourself, but you're not by yourself." McDonald's would flourish only if the individual franchisees were successful.

On March 2, 1955, Kroc founded McDonald's System Inc. (now known as McDonald's Corporation) and on April 15, 1955, he opened his own McDonald's drive-in in Des Plaines, Illinois so that prospective franchisees could see a model store in operation and provide CPA certified income statements showing how much money these little hamburger stands could generate.

On average, a McDonald's stand at this time generated about \$200,000 in sales yielding \$40,000 in profits. Based on this information:

\$200,000	Gross Sales
\$3,800	Service Fee (1.9% of Gross Sales)
LESS \$1,000	Royalty to McDonald Brothers (0.5% of Gross Sales)
\$2,800	Remitted to McDonald's System Inc.

Under this system, financing the support infrastructure Kroc aimed for was unobtainable. Kroc demanded military-like adherence to standardization and uniformity, both from individual licensees and from a myriad of suppliers. To enforce this Kroc would need a contingent of field inspectors, along with specialists responsible for developing and refining various "back room functions" such as: establishing operating procedures, quality standards, finance, logistics, advertising, new product development, site selection and building construction. The problem now became how to finance a growing franchise organization without cash, collateral or even a record of profitability. Compounding this problem was the fact that the independents he wanted as licensees usually didn't have the startup money on hand, nor were they likely able to obtain a bank loan (then, as now, banks

were reluctant to provide loans for restaurants due to their high failure rate).

What Ray Kroc desperately needed was a “numbers man” who was well-versed in finance and could be as enthusiastic about McDonald’s as he was in running the operations side. Without such a person, McDonald’s would face bankruptcy in a few years due to undercapitalization.

A New Kind of Sandwich

TasteeFreez executive Harry J. Sonneborn was looking for new opportunities in 1956. Aside from being a “numbers man,” his other talent lay in his ability to persuade bankers to loan him money when he needed it. Sonneborn had the rare talent of understanding numbers like a banker, knowing the language of real estate brokers and being able to construct a contract like a lawyer. Sonneborn contacted Kroc through a mutual friend and was immediately hired as Kroc’s top financial officer.

Sonneborn’s first order of business was to find a way for the McDonald’s Corporation to make money that did not conflict with Kroc’s concept of fairness to his franchisees, but would allow the company to maintain control over them so they would comply with his operating directives. Several of his first licensees were already ignoring his rules on operations management. Sonneborn realized that “fundamentally, the company couldn’t make a profit on its franchise income because the bulk of it [remitted to McDonald’s Systems, Inc.] was expensed as overhead.”

To give a sense of how undercapitalized McDonald’s was at this time, it lost \$7,000 in 1956. In 1957 the company earned \$26,000, most of which was from one-time licensing fees charged to new franchisees. At the start of 1958 McDonald’s had a net worth of just \$24,000 with 38 restaurants, and Kroc wanted to add 50 more units.

Sonneborn also expressed little faith in the contract McDonald’s had with its licensees. “I never thought the franchise

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contract was worth the paper it was written on. It appeared that it could never stand up in a legal action.” At the time, there wasn’t much case law dealing with franchise contracts.

But there was with real estate and lease agreements.

In order to satisfy Kroc’s requirements, Sonneborn got the company into the “landlord business” by devising a unique real estate investment strategy. He formed a separate and wholly owned real estate subsidiary in 1956 called Franchise Realty Corporation. FRC was tasked to locate and lease sites from landowners who were willing to build McDonald’s units, which then would be leased back to the company on a 20-year improved lease agreement with the property owner. McDonald’s would then take “sandwich position” by subleasing the store to the franchisee and charging a 40% markup for the real estate services Franchise Realty was providing.

Here is an example of the arrangement if the landowner charged McDonald’s \$600/month:

Rent Paid By Franchise Realty to Property Owner	\$600
40% Markup Charged by Franchise Realty to Licensee	\$240
Rental Fee Remitted to Franchise Realty	\$840

In addition to the franchisee’s base rent, FRC added an interest charge. Franchisees would stop paying the minimum base rent and start paying rents based on a percentage of their sales when the store reached a sales volume equal to 5% of sales (which rose to 8.5% in 1970).

Sonneborn’s plan provided three main benefits:

1. The McDonald’s Corporation received a steady and predictable minimum cash flow to cover its overhead costs. This cash flow would increase with every unit they opened.
2. Because the more money the franchise made, the more McDonald’s made, this provided the motivation for corporate directed site selection to be meticulous when analyzing prospective locations. This maintained Kroc’s dictum that the success of McDonald’s be aligned with the success of the individual franchisee.
3. By gaining control of the real estate and building, McDonald’s could exercise control over the franchisee by making him a tenant. Licensees not abiding by the terms of the franchise agreement could be evicted. Among the terms, the franchisees were on a “net net” basis, meaning they were responsible for paying property insurance and taxes.

Reinterpreting the Numbers

FRC came into existence by leasing the land and owning the building, and then charging rent on both from the licensee. But at the time McDonald’s was cash poor (Kroc’s Multimixer business and his own franchise sustained him during this period), and Sonneborn was already making plans to buy the land as well. At this time, there was a flight

of city dwellers to the suburbs, and many of the sites McDonald's sublet to franchisees appreciated rapidly. But, as stated earlier, banks are reluctant to provide loans for restaurants due to their high failure rate, and given McDonald's anemic balance sheet and income statements, banks would be equally reluctant to lend them money.

In 1958 Sonneborn hired Richard Boylan, an eight-year veteran of the IRS who specialized in real estate accounting, appraisal and taxation.

Boylan beefed-up McDonald's balance sheet by using IRS valuation techniques to increase the company's reported net worth by extending an interpretation used in estate appraisal. The IRS had determined that the future lease payments to a deceased's estate had a present value. Using this rule, Boylan concluded that McDonald's future net rental income from its franchisees had a present value as well, and that should be reported as an asset—assessed at roughly 10 times what McDonald's collected in rents from franchisees. This also reflected the effect of appreciating real estate values that McDonald's was creating through the future income stream that grew every time McDonald's opened a new unit and subleased the property. By capitalizing the leases in this manner, by 1960 McDonald's could proudly boast a balance sheet with total assets of \$12.4 million, impressive enough for major lending institutions to provide multi-store financing packages.

Boylan performed an encore with McDonald's reported earnings which were equally low (\$12,000 in 1958) because the costs related to building new units showed up on their financial documents before new restaurant-generated revenues.

Traditionally, a company expenses real estate development costs as they are incurred, but Boylan argued that they should be reported nine months later, when the expenses could then be matched to the revenues they generate. His reasoning

was that it took this much time to develop a site, and real estate expenses did not generate revenues until new stores were open. Boylan also convinced Sonneborn to capitalize interest expenses on real estate loans during the construction of a store and amortize those costs over the 20-year life of a franchise. Both of these techniques were designed to delay the reporting of expenses during a time when McDonald's was building units as quickly as new franchisees were found to operate them. As a side benefit, the delaying of expenses would help generate an income statement that reported earnings when ordinarily there wouldn't be any.

The Buy Out

By 1961 Kroc felt he was doing all the work of creating a hamburger chain and the McDonald brothers had not contributed anything (except for devising the original Speedee System). Every time he needed to make a format or procedural change, he required their written permission, and they were often lackadaisical in their responses. Finally Kroc called them and asked how much it would take to buy them out?

The response nearly gave him a stroke, "We want \$2.7 million, which would leave us one million each after taxes."

Kroc swore, but he knew if he wanted complete control he had to capitulate. At the time there were 228 units with sales the year before of \$37.8 million. Of that the brothers had received 0.5% (or \$189,000) representing their royalty. A New York money manager arranged a loan from several college endowment and pension funds, along with a \$1.5 million loan from State Mutual, which accepted the risk in exchange for 20% of McDonald's stock.

Today, with system-wide sales of over \$61 billion, if both Ray Kroc and the McDonald brothers had been more flexible with their franchise agreement, the royalty paid to the McDonald brothers (or their heirs) would be \$305 million! \$

Notes

1. After the *American Restaurant* magazine article appeared, the brothers were besieged with inquiries about their operation. Within two years the brothers sold 15 franchises to their "Speedee System" for a one-time fee of \$1,000 which included the store plans and a description of their system. No further assistance or support was given.
2. This was not the first place Ray Kroc tried to obtain a national franchise agreement. In 1949, on West Pico Boulevard in Los Angeles, Kroc made an offer to the owners of The Apple Pan, a restaurant known for their hickory flavored hamburgers, tuna salad sandwiches, and apple and pecan pies, but the owners turned him down. Carl Karcher, founder of Carl's Jr., said that at one point Kroc had extended a similar offer to him before he went into the hamburger business when he owned a few hot dog stands and barbecues.
3. To this day, McDonald's does not hold an equity position in any of the suppliers it does business with. Aside from establishing the operating procedures individual franchisees are required to follow, McDonald's Incorporated also establishes for its suppliers the recipes for every item of food they sell or use, and the specifications for quality. Even the recipe for the brine used to cure cucumbers into pickles was devised by McDonald's.

Steven Mark Adelson is a graduate of the University of Maryland and the US Army School of Logistics. He is now a freelance writer and lecturer on research techniques. He gained first-hand knowledge of restaurant operations as a teenager by working at Sam's Grill, owned by his father, in Washington, DC. He is also an executive member for the Society of Southwestern Authors located in Tucson, Arizona.