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McDonald's in Southeast Asia: Industrial Organization and Foreign Direct Investment

By

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Faculty Comments

(Evaluative comment in which the faculty supervisor should briefly describe the nature of the research project and add an evaluating comment)

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INTRODUCTION

The first-time visitor to any major city in Asia is likely at some point to remark on the surprising ubiquity of American fast-food brands. Almost anywhere one goes, the golden arches of McDonald's, an image of Colonel Sanders with the letters KFC, and the red-roof motif of Pizza Hut seem never far away. To most Americans the sight of these familiar symbols from home is strangely reassuring, even for those who profess regret at such Western intrusions on the exotic cultures of the East. But any culture is only exotic to those from outside, and no one complains about or finds remarkable the proliferation of Chinese, Thai, and Vietnamese restaurants in the United States.

In simple fact, there is nothing inherently American about the beef, cheese, and bread entrees served up by McDonald's, especially when accompanied by something we call *french* fries. Pizza, though perhaps adapted to its present popular form in New York, is still considered an Italian food and often shares its place on the menu with spaghetti, a food the Chinese are quick claim as their own. And who really invented fried chicken? For anyone who has visited the markets, street vendors, and village kitchens of Southeast Asia, it was obviously not the discovery of some old man from Kentucky.

What is truly remarkable and uniquely American about the fast food industry is not the food, but the innovative business concepts and entrepreneurial drive that made it famous. These too are what make the story of American fast food in Asia so interesting. Pioneering companies like McDonald's and KFC were not just selling a different kind of food, they were selling a different way of doing business. An often forgotten fact is that fast-food operators were among the first American retailer to venture overseas, much less to Asia, where the local business practices and traditions differ greatly from those in the

West. With each new market these companies faced more than just language and cultural barriers, they also encountered different systems of government, with complex and often opaque laws, regulations, and bureaucracies dealing with business registration, foreign ownership limitations, import restrictions, duties and taxes. Also uniquely different were the local banking systems, financial and real estate markets, construction methods, labor markets, and even advertising practices. There was also a need to identify local suppliers who could provide their food and other requirements to reduce operating costs and meet local content requirements. In short, these companies had to adapt their business models and organizations to meet the unique challenges posed by each new market they entered. It was a daunting task, but the industry leaders knew there were potentially huge rewards for the first who could be successful in Asia

The research presented in this paper began with a much broader scope. The goal was a cross-country comparison of the leading American fast food firms in each of the countries of Southeast Asia. The emphasis was to be on their different entry strategies, in particular their choice of organizational forms and levels of foreign direct investment, and how these determined their development over time. It soon became apparent that the scope of such an investigation went well beyond what was possible for a single research paper. Not only were the issues complex and the geographic coverage broad, there was very little information publicly available that summarized what any these various firms had done in Asia. Nor was there much hope of getting specific information from the companies themselves. Although most are public companies, their Asian subsidiaries, affiliates, and franchisees usually are not, and financial reporting requirements often extend no further than consolidated results by geographic region (say, Asia/Pacific).

There is little to be gained by a company in providing information on local operations that might be considered confidential (or worse, potentially embarrassing to the company or its local partners). In addition, much of the information required for this study is not current or even recent, but dates back to the company's initial entry into a new Asian market some 15, 20, or even 30 years ago. Attempting to compile such data would be a difficult and time-consuming task even for company insiders. For all of these reasons, it was decided that a more focused approach should be taken in the current research.

This paper therefore presents an investigation into one company's experiences in Asia: McDonald's Corporation. McDonald's was chosen for three main reasons. First, it has long been a leading fast-food firm not just in American but worldwide. McDonald's also ranks closely behind Coca-Cola as one of the most recognizable brands throughout the world. Second, McDonald's has established a local presence in a greater number of Asian markets than any other fast-food company (though it is closely followed by KFC). More important, from all available evidence McDonald's has been the successful of all American fast-food companies in Asia, at least in terms of market penetration. It holds either first or second place in nearly every Asian market it has entered, whether measured in terms of total sales, customer visits, number of outlets, or brand recognition. And third, due to its ubiquity and relative openness among firms in the industry, there is more information available on McDonald's in Asia than for any of the other companies. This last factor was critical, since the nature of this research required an almost total reliance on secondary sources. Under such circumstances, there is an even greater need to clarify, confirm, and cross-reference certain facts (and sometimes also to read between the lines) for a more complete understanding of events. Having access to a greater number of sources was therefore critical to developing an accurate and detailed data set upon which to base the results and conclusions of this research.

At least three books have been written about McDonald's, parts of which have some relevance for this study. The first of these, *Grinding it Out*, is an autobiographical account of Ray Kroc, the founder of McDonald's Corporation and a main architect of the business.[1] First published in 1977, it gives Kroc's perspective on the early history of McDonald's, but says almost nothing about the firm's later international expansion. A second book, *McDonald's: Behind the Arches*, by John F. Love, is perhaps the definitive account of McDonald's Corporation.[2] The author, a journalist by trade, received the cooperation of the company, which provided information from its historical records and granted interviews with senior executives. First published in 1986, this book presents an impartial and highly detailed description of McDonald's history up to that time. While it presents in general terms McDonald's initial overseas expansion, *McDonald's: Behind the Arches* gives few details on local-country operations and organization and was written before McDonald's had entered some of the Southeast Asian markets. A third book has more recently appeared that specifically deals with McDonald's in Asia. *Golden Arches East: McDonald's in East Asia* is a collection of essays written by several academic anthropologists on local acceptance and reactions to McDonald's in different East Asian markets, specifically China, Hong Kong, Taiwan, Korea, and Japan.[3] While it contains some facts and insights of relevance to this study, *Golden Arches East* is much less a book about business history or strategies than a study of social and cross-cultural issues

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[1] Kroc, Ray, with Robert Anderson, *Grinding it Out*, Contemporary Books, 1977 (St. Martin's Paperbacks Edition, 1987).
[2] Love, John F., *McDonald's: Behind the Arches*, Bantam Books, 1986 (Bantam Revised Trade Paperback Edition, 1995).
[3] Watson, James L, editor, *Golden Arches East: McDonald's in East Asia*, Stanford University Press, 1997.

in different countries, and may thus have greater relevance to those specifically interested in McDonald's marketing, advertising, and public relations efforts in Asia.

Although the initial scope of this study was limited to McDonald's in Southeast Asia, it soon became apparent that the company's earlier experiences in Japan and Hong Kong had a profound effect on the choices it made when entering Singapore, and later the Philippines and Malaysia. Japan in particular, being among the earliest overseas markets it entered, is an interesting case study with direct relevance to McDonald's practices in other parts of Asia. Taiwan also presents an interesting case study, in part because of an apparent falling out between McDonald's and its local joint venture partner, something that is rather rare in the company's history. Taiwan also has many features in common with Southeast Asia, and thus provides useful data for making general conclusions about the region. Finally, a decision was made to include South Korea in this study. Not only is it a market of similar size and potential to those in Southeast Asia, it also shared in the economic turmoil of the currency crisis that swept Asia in 1997. McDonald's response to the crisis in South Korea is thus usefully compared with what it did in Southeast Asia, and suggests a remarkable consistency in company policies through out the region.

Of course one could continue on with an investigation of what will likely become McDonald's most important Asian markets, China and India. However, such a study (though interesting in its own right) would add little to our understanding of the situation in Southeast Asia. The conditions affecting business in China, and McDonald's response to them, are simply too different from those in Southeast Asia to make any comparisons useful. India, although in many respects more similar to Southeast Asia, is probably too new as a McDonald's market (established in 1996) to yield much information of interest.

The following section is based largely on John F. Love's work, and is intended to give the reader background on the early history of McDonald's Corporation, prior to expanding overseas. Understanding the company's philosophy and practices, particluarly with respect to franchising and supplier relationships, is critical if one is to appreciation the decisions it make in developing entry strategies for new markets in Asia.

The third section in this paper is a brief description of McDonald's initial efforts at international expansion. These ventures proved less successful than the company had hoped, and it soon modified its plans and strategies in response. Nevertheless, some of the lessons from these early international adventures have direct relevance to the leap of faith McDonald's made when it entered Japan in 1971.

The remainder of this paper presents an accounting of facts and events (along with some reasoned speculation to fill in the gaps) that describe McDonald's entry and development to the present time in each the study markets. The company's experience in each country is discussed in a separate chapter that presents in a roughly chronological progression its entry strategies, initial local organization, early development and growth of the chain, establishment of local supplier networks, and significant transitions, such as changes in local ownership and the responses to the Asian currency and financial crisis.

This paper then concludes with another chapter entitled summary and conclusions that attempts to highlight some common themes and patterns, and how these are related to McDonald's initial strategic decisions including its local organizational forms and its level of foreign direct investment in different markets.

CORPORATE BACKGROUND

To understand McDonald's success in Asia, one must know something of the background of this quintessentially American company – how it evolved and operated in the United States prior to the beginning of its international expansion. Only in this context can one truly appreciate the critical decisions that were made as McDonald's ventured into new countries with very different cultures and traditions. The main purpose of this section is to briefly acquaint the reader with what has come to be known as the 'McDonald's System'. This is not intended to be a comprehensive portrait of a complex business organization, nor does it present any original research or analysis on the subject. For that the reader is directed to John F. Love's excellent book, *McDonald's: Behind the Arches*, which serves as the principle source for the information presented in this section.[1] Instead, this section attempts to present in summary the key events and critical decisions that shaped the company and its business relationships, and the perspective of its leaders as they embarked for new ventures in Asia.

The Beginnings

The early history of McDonald's is by now almost legendary.[2] It began with two brothers, Richard and Maurice (Dick and Mac) McDonald, who left their native New Hampshire not long after high school and moved to California in 1930 looking for new opportunities in the wake of the depression. After an unsuccessful four-year stint operating a movie theater in Glendale, the brothers opened a tiny drive-in restaurant just

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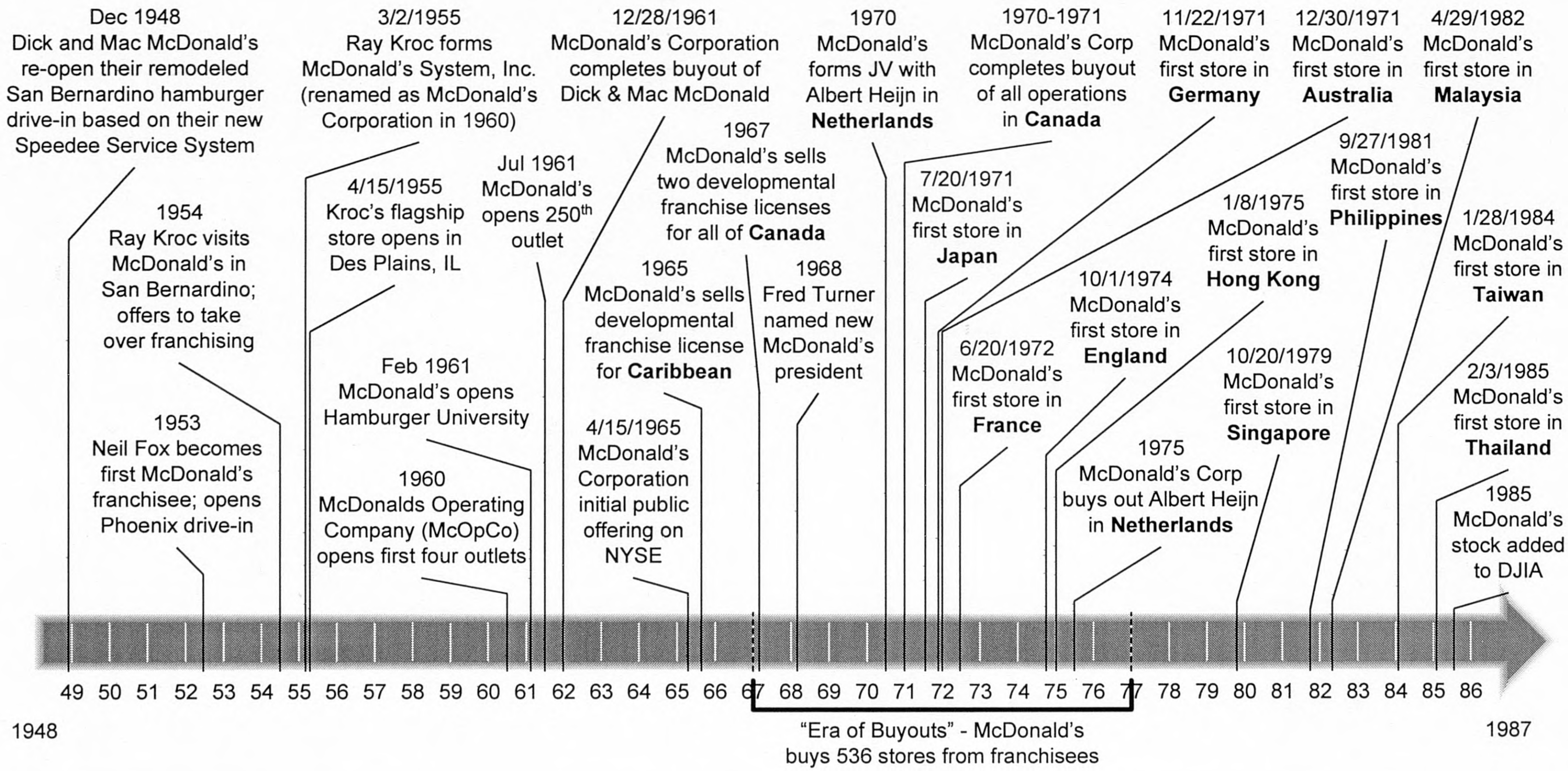
[1] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995.
[2] Unless otherwise noted, the information presented in this sub-section on McDonald's early history is drawn from "Chapter 1, Yes There Is A McDonald" and "Chapter 2, The Salesman", in: Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 9-47.

Figure 1
McDonald's Early Corporate Timeline



east of Pasadena in 1937. They wanted to be part of the drive-in boom that was sweeping automobile-crazy California. Their initial efforts were successful and led the brothers to open a much larger drive-in restaurant in San Bernardino in 1940. As the first local drive-in it was hugely successful, but by 1948 there were several imitators. A booming economy also caused changes in the local labor market that forced the brother's to rethink their business.

They responded based on their intuition and closed the business for three months in the fall of 1948 for a total redesign of their kitchen, production system, and menu. When the new McDonald's drive-in reopened in December 1948 it was all about hamburgers. Gone were the carhops and barbecue pit, replaced by an animated chef named Speedee and a 'fishbowl' style kitchen – the heart of their new Speedee Service System – that itself was an attraction. With the addition of shakes and french fried potatoes, the new format soon became a hit. A combination of self-service, paper service, and quick service were the keys to speed and efficiency that was never before seen in the food service industry. The operation soon became a model for others in the fledgling fast-food business, and when *American Restaurant Magazine* ran a cover story on the phenomenal success of the McDonald's concept in July 1952, the brothers were flooded with letters and telephone inquiries.[3]

Given all this attention, the McDonald's concluded that they should begin franchising their Speedee Service System, so they ran a full-page ad in a trade magazine seeking franchisees. Neil Fox, an independent gasoline retailer, became their first licensee in 1952. The brothers decided to make his Phoenix drive-in a prototype for the chain they now wanted to build. As their architect objected to the idea, the brothers went

[3] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, p. 20.

behind his back and hired a sign maker to design and built one critical feature of the new restaurant – the now famous "golden arches". However, the rest of their franchising program left much to be desired:

> Fox, whose Phoenix store opened in 1953, was provided with plans for the building, a one-week loan of Art Bender [the first counterman to work at the McDonalds' revamped San Bernardino store], and a basic description of the Speedee Service System – all for a one-time franchise fee of USD 1000. After that, the first McDonald's franchisee was on his own, financially and operationally. The McDonalds had no continuing revenue, and thus no economic incentive to help ensure their franchisee's success, and the franchisee was not required to follow any of their procedures. The brothers' licensing program amounted to little more than a rent-a-name scheme.[4]

Not surprisingly, the McDonald's franchising program failed. In their first two years, the brothers sold just 15 franchises, 10 of which became operating McDonald's units. Aside from missing out on opportunities to sell more lucrative franchise deals, there was no control over the franchisees with regard to procedures, quality, prices, or even menu items. Meanwhile, others were scrambling to imitate the McDonalds' concept, and some launched much more effective franchising programs of their own. Worse, many of these new competitors were aided in their efforts by the McDonalds, who would naively give tours of their kitchen and answer questions about their operating procedures and suppliers. The reason was simple, the brothers had no burning desire to grow their franchising business – they were quite contented with the annual net profit of USD 100,000 the each received from their single San Benardino burger factory.

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[4] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, p. 22.

This was the environment into which Raymond A. Kroc, a curious Multimixer salesman from Chicago, walked when he made his first visit to the McDonalds' drive-in during the summer of 1954. Kroc owned the national marketing rights to the five-spindle Multimixers that the brothers McDonald used to make their milk shakes. Having heard about their operation from his West Coast sales representative, he decided to see for himself how a single hamburger joint could possibly have bought ten of his Multimixers.

Kroc himself had no direct experience in restaurant operation, but his twenty-five years of selling new retailing concepts to the food service industry gave him an insider's perspective on the industry and the growing trend in convenience foods. He knew the McDonald brothers were sitting on a potential gold mine, but his initial thoughts were of how to revive his flagging Multimixer business. With this in mind he offered to take over exclusive franchising rights to McDonald's. The brothers agreed, but with conditions. They insisted that he keep the initial franchise fee low, initially at USD 950, and charge each franchisee a service fee of only 1.9 percent of store sales. Of that amount, Kroc's company could keep only 1.4 percent to cover the costs of servicing the store, with the remaining 0.5 percent going to the McDonald brothers for the user of their name and fast-food system. It was actually a very one-sided deal, and reflected both Kroc's desperation at the time and the brothers' lack of appreciation for what was required to properly service the franchisees.

On 2 March 1955, at fifty-two years of age, Ray Kroc formed McDonald's System, Inc. (the name was later changed to McDonald's Corporation in 1960). From the beginning, Kroc knew it was important not to deviate from the basic format developed by the brothers. He also resisted the temptation simply to steal the brothers concept as others had done, realizing that to do would ultimately cost him in intangible ways as he repeated mistakes made years before and solved by the brothers. This same pragmatism that led him to take a totally new approach to franchising, based on a personal philosophy that his own long-term success was dependent on the success of his franchisees:

> In all other food franchising schemes, franchisers made their profits before their franchisees did, either by selling franchise territories to investors for huge up-front fees or by supplying franchisees with food, paper, and equipment – typically at markups that were higher than they would pay on the open market. By comparison, everything in Kroc's franchising plan was designed to encourage the success of his franchisees first, and on that McDonald's would prosper.[5]

Kroc on Franchising

The salesman in Kroc understood that franchisees were his customers, and he approached selling the McDonald's concept much in the same way he sold kitchen equipment.[6] If you have a good product, there is no need to change it – the time, expense, and risks involved are simply not worth it. But the most important thing is to make your customers successful in using your product. He therefore stuck with the basics of the McDonald's proven concept – good food, fast service, and limited menu choices (hamburgers, shakes, soft drinks and french fries) – when he opened his first McDonald's restaurant in Des Plains, a suburb northwest of Chicago, in 1955. However, from the first day his team began making changes to the operating system. Ray Kroc instinctively assumed that the Speedee Service System itself could be upgraded. Although he lacked

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[5] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, p. 43.

[6] Unless otherwise noted, the information presented in this sub-section on Ray Kroc's philosophy and McDonald's early franchising practices is drawn from "Chapter 2, The Franchising Derby", in: Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 48-66.

the expressed rights to make any changes without written approval from the McDonald brothers, much of his early efforts were directed toward defining, refining, and implementing the operating system (and none his changes received formal approval):

> Kroc decided that to build a national chain – one that could be licensed to hundreds of newcomers to the restaurant business – he would have to develop a far more refined system of operation than the McDonald's had employed in San Bernardino. He needed a system that was so solid and yet so simple that it could convert novices into strong operators within weeks. Thus, from his first day of operations in Des Plains, Kroc and his operations staff began making substantial modifications to the brothers' techniques, knowingly putting McDonald's Corporation in clear violation of its restrictive contract.[7]

The flagship store in Des Plains therefore served as both a training ground for operations staff and a model unit to demonstrate the McDonald's concept. In selling that concept, Kroc was careful to be honest and open with his prospective franchisees. He not only explained all aspects of the business, but often showing them the books from other operating units to convince them of the potential rewards. Although he made no promises about their own results, his staff worked closely with franchisees to help ensure their success using his 'product'.

Kroc's basic franchising formula differed from that of other fast food chains in several respects, perhaps the most important of which was the avoidance of territorial franchises. Selling exclusive operating licenses for large markets, such as a state, is the fastest way for a franchiser to make money. However, the correspondingly large franchise fee saddles the franchisee with a huge up-front cost that delays the return on

[7] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, p.118.

investment and encourages selling sub-franchises. Both factors make it extremely difficult to exert central control over development of the chain; with so much at stake, the franchisee will insist on developing his territory as he sees fit. This can result in quality problems and a lack of uniformity that affects the entire chain. A greater problem with territorial franchising is that a mistake in choosing a franchisee is immediately magnified, since the franchisee has a contractual right to put up an unlimited number of units in his exclusive territory.

As a salesman, Kroc had seen problems with territorial licenses in other chains and was determined to avoid them as he built McDonald's chain. He established greater control over his franchisees by selling one franchise at a time to operate only one store.

> While some early franchisees were granted territories for metropolitan areas, such as Washington, DC, Cincinnati, and Pittsburg, Kroc quickly began to cut down the area covered by a franchisee to a one- or two-mile radius, and by 1969 to the street address of the store. Even in his territorial agreements with early operators, Kroc did not *sell* territorial rights; he *gave* them away. Nor did his territorial agreements give franchisees the right to build as many new McDonald's units in their territories as they chose to build... [They] merely had the right to obtain additional stores *if McDonald's* chose to put additional stores in their territories. They could keep McDonald's from granting stores to anyone else in their territories, but they could not demand new stores for themselves.[8]

In this way, McDonald's could – and did – limit to just one store its early territorial licensees who had poor performance records. Conversely, a successful and trusted operator of a single-store franchise might be allowed to open a second store within his

[8] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, p. 59.

local community. The key to success in Kroc's view was uniformity, and by retaining the right to determine whether or not a franchisee is granted a license to operate a second store, McDonald's retained the ability to motivate a franchisee to follow the system's rules on quality, service, cleanliness, and value.

As a second feature of Kroc's franchising formula, he resisted the temptation to make big profits by selling products and equipment to his franchisees. "That policy also went against the industry's grain. Virtually all other major fast-food franchisers made a good portion of their profits on the markup on goods they supplied to their customers."[9] However, by requiring their franchisees to buy products only from them, franchisers create the appearance – real or imagined – of a conflict of interest between themselves and their franchisees. Worse, as the orientation of the franchisers shifts increasingly to profits they make as suppliers, rather than as retailers, there is a tendency to spend more effort running their manufacturing plants and commissaries, with less attention being paid to store operations and retail customers.

> Kroc understood that selling high-priced territorial franchises and profiting on sales of supplies to franchisees share a fundamental weakness: the franchiser made most of his or her money before the franchisee's restaurant even opened and thus was less dependent on that restaurant's success for profits.[10]

This philosophy extended to Kroc's insistence that McDonald's would not accept any kickbacks or rebates customarily offered to franchisers by the suppliers of their franchisees. He realized one advantage of a franchised system was obtaining the benefits of cooperative purchasing so that individual restaurant operators in the chain could sell

[9] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, p. 61.
[10] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, p. 63.

their food at a lower price than if they operated independently. This advantage was critical, because in McDonald's System, with its low initial franchise fee, there was only significant source of revenue – and that was totally dependent on the sales volume of the franchised store. Thus McDonald's interests were aligned with those of its franchisees.

Suppliers – The Other Partners

McDonald's reputation as an innovative and fair-dealing franchiser is today well known, but what is less widely appreciated is how McDonald's changed the food processing industry by making suppliers partners in its success.[11] Kroc set the tone in his early dealings with food and equipment suppliers by emphasizing a spirit of cooperation and strict adherence to quality standards over price. "His approach was totally pragmatic. He and his operations staff were doing too many other things to waste time looking for bargains on supplies from week to week."[12] What did matter to Kroc was honesty and reliability, and a clear commitment to meeting McDonald's specialized needs.

McDonald's was constantly on guard for the tricks food suppliers commonly tried, such as extending hamburger meat by adding soy meal and water, or substituting inferior potatoes for the specified No. 1 Idaho Russet, and the company wasted no time in severing ties with suppliers who cheated. On the other hand, McDonald's was extremely loyal to suppliers who proved themselves trustworthy over time, even when they did not have the lowest price.[13]

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[11] Unless otherwise noted, the information presented in this sub-section on McDonald's suppliers is drawn from "Chapter 14, 'McDonaldizing' The Suppliers", in: Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 321-353.

[12] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 135.

[13] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 129-133.

Another important factor to McDonald's was a supplier's willingness to change its product or production process to meet McDonald's standards. McDonald's conducted extensive research to determine what food supplies and equipment worked best, and it then set exacting standards for suppliers to meet. A famous case in point was the development of the McDonald's french fry, which gave the company its most significant product differentiation and probably drew more customers to the chain in its early days than did its hamburgers. These famous fries were not the same as were served by the McDonald brothers; rather they were the result of ongoing research efforts that began soon after Kroc took over development of the chain. The initial studies were fairly simple, to determine optimum temperature and time settings for cooking the fries. An unexpected discovery, however, was the importance of properly curing the fresh potatoes prior to use. Subsequent studies led McDonald's to establish quality standards for its potato suppliers, such as a minimum solids requirement of at least 21 percent. Eventually the research identified other critical factors throughout the potato supply chain, from planting and fertilizing practices to storage, handling, and transportation methods. Other research determined the effects of using different kinds of cooking oils, and changes to the cooking technology.[14]

As a result of McDonald's quest to perfect the french fry, McDonald's developed strict requirements for suppliers – and the same is true for its other products. In the early days, many established food suppliers simply refused to entertain McDonald's special supply requests, which at the time were rather unusual. This was especially true of big food companies whose business was oriented more to retail sales than servicing

[14] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 119-126.

institutional customers. They were unwilling to change their products for what they considered a small account, particularly if doing so would require them to build special production facilities instead of simply maximizing utilization of existing capacity.

As a result, McDonald's was forced to seek out new suppliers who were willing to meet its highly specific requirements Often these were small, unknown firms that obviously lacked the economies of scale to compete on price. What they could and did do, however, was accept a gamble proposed by Ray Kroc. He promised them loyalty and a fair profit in exchange for their commitment to invest in McDonald's needs. Being small, these highly entrepreneurial firms were dependent on McDonald's for their growth, and this encouraged them to be loyal in return. Those who were willing to reinvest in new technologies and production capacity were rewarded with additional business from McDonald's as the chain grew.

By the late 1960s it was already becoming apparent that the fast-food business, and in particular the hamburger segment, was heading for a major consolidation that within a decade would leave but a handful of national leaders. After that, competition would increasingly be based on efficiency of supply, with the winner being the one whose suppliers had the lowest costs, best technology, and commitment to innovation. Other major fast-food chains had supply agreements with the major national suppliers, or were owned by them. Obviously McDonald's could not compete by relying on a large number of small, independent suppliers. It therefore changed both in its production and supply systems:

> In the 1950s, McDonald's achieved its extraordinary consistency by devoting more attention than anyone else to field service and training at the store level. But, beginning in the late 1960s, the chain began shifting

> some of the labor involved in food preparation at the stores back to the food plants who supplied them. Products were produced in a more standardized fashion and in a manner that made food preparation in the store nearly foolproof. Production was concentrated in huge plants devoted exclusively to McDonald's. By the mid-1980s, McDonald's had converted its distribution system into the marvel of the food processing business.[15]

Although it was an impressive transformation, the real key to McDonald's success is not how it changed its supply system, but rather how it did not. Most of the company's big suppliers actually began their relationship with McDonald's as tiny firms that grew with the chain. As a result, McDonald's still accounts for the vast majority of their business (and in many cases, they are exclusive suppliers to McDonald's.) Over time, these suppliers came to understand and appreciate the McDonald's system, and became as dedicated to maintaining and improving the quality of that system as they would if owned by McDonald's. In fact, given their independence and entrepreneurial spirit, they may exceed what might be expected from an in-house supplier:

> They not only monitor their own quality control, they check on the quality of other suppliers in the system. They maintain their own quality assurance staffs, which regularly visit the restaurants to determine that products are being properly prepared and stored. They even check the company and take issue with corporate managers when they believe the integrity of the system's network is threatened.[16]

[15] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 324.

[16] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 325.

Since the 1960s, McDonald's suppliers have also been an integral part of the company's new product program. Most of the McDonald's new products were made possible only because its suppliers were willing to risk a substantial investment in new production technology, without any guarantee the product would be successful.

Such was the case in the early 1960s when one of its major potato growers, Jack Simplot, approached McDonald's with an idea to improve the consistency of its french fries. At the time, the best potato for french fries, the Idaho Russet, was only available on the fresh market nine months out of the year. During the summer months McDonald's was forced to use an inferior quality potato. Simplot already supplied 20 percent of McDonald's potatoes, but knew he could do better than that if he could improve the current storage system. He spent USD 400,000 to put three hundred carloads of potatoes into cold storage around the country. It had never been tried before, and McDonald's offered him no guarantees. As it turned out, nearly all of the potatoes spoiled and Simplot was stuck with a USD 400,000 loss. However, his commitment made the company more receptive when he came up with another unproven idea to improve quality by supplying partly-cooked frozen french fries to McDonald's restaurants. McDonald's put their new food lab technicians the task of developing the new production process, which proved so successful that it resulted in a patent for McDonald's. Simplot offered to build a production facility using the process and, on a handshake agreement with Kroc, invested USD 3.5 million in the project – again with no guarantees. But the gable paid off. By 1972 McDonald's had completely converted to using frozen french fries, and Simplot's company was supplying more than half of the company's needs.[17]

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[17] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 327-333.

In another example, three entrepreneurs, one a small meat processor, had an idea for cryogenically freezing hamburger patties. Their efforts to sell it to McDonald's began as early as 1965, but it was not until 1967 that the company agreed to a limited test of their frozen meat. The partners then put USD 250,000 each into a new firm, Equity Meat Company, to develop the process. McDonald's standards were extremely high (despite the obvious storage and handling problems, fresh beef was still considered superior to frozen beef), but the test was ultimately a success. Customers liked the frozen patties as well as fresh ones, and the company liked the fact they cooked faster with less shrinkage. McDonald's operators had the final say on purchasing, but by 1973, just two years after the test began, virtually all stores in the system had converted from fresh to frozen meat. Equity Meat was in no position to satisfy that demand. However, it had already agreed to a standard condition that all McDonald's suppliers accept: if a supplier develops a new product or production process exclusively for McDonald's, it must make that technology freely available to any other supplier McDonald's designates. Knowing McDonald's record of enriching its suppliers, Equity Meat gladly accepted this condition when it entered into its product development agreement with McDonald's in 1970. It willingly turned over the secrets of its cryogenic hamburger production to four meat suppliers McDonald's considered the best of the 175 local companies supplying its stores with fresh meat. Not surprisingly, Equity Meat, which later changed its name to Keystone Foods, has consistently gotten the largest share of McDonald's meat business. In just over twenty years, the firm grew from a USD 4 million per year meat de-boning operation to sales of USD 750 million in 1990 – all of which went to McDonald's.[18]

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[18] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 333-338.

Not all of McDonald's suppliers are manufacturers. Some of its most important suppliers make nothing themselves, but focus solely on meeting the company's logistical needs. Consistent with Ray Kroc's aversion to the commissary system used by other fast food chains, each McDonald's unit made its own purchases from approved suppliers. As a result, different trucks showed up several times a week to deliver fresh buns, cheese, meat, paper goods, soft drinks, and a host of other supplies. A McDonald's paper goods supplier in Chicago saw the inefficiency in this, and proposed that his company supply all McDonald's needs from a central warehouse. He reasoned that lower costs from volume purchasing would easily offset warehousing and higher distribution costs. Extending this concept to other supply needs, he soon combined all dry goods requirements into a single shipment, thus reducing both the number of deliveries and on-site storage requirements at McDonald's stores. Another supplier, a meat producer in California, had aggressively expanded his plant and warehouse in 1962 and was struggling to find enough business to stay profitable. He began buying and warehousing frozen fish, cheese, pickles, ketchup, soft drink syrups, potatoes and sauces, and delivered these to McDonald's along with its own meats. The same firm was later selected as one of the five suppliers of frozen beef patties, it was able to expand its food distribution services to McDonald's restaurants over an even larger area. Seeing greater efficiencies in this 'total distribution concept', McDonald's Corporation encouraged its development, and several of its other suppliers soon followed these early examples. As a result, McDonald's went from having about 200 distributors who served 1500 outlets in 1970 to just ten distributors in 1993, four of which handled all supply deliveries to more than 85 percent of the chain's 9000 units.[19]

[19] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 343-347.

McDonald's Corporation set quality standards and ensured uniformity of products across its units, but individual operators ultimately made the purchasing decisions. Just as McDonald's suppliers and distributors became more concentrated beginning in the late 1960s, so too did McDonald's franchisees, who formed regional cooperatives to increase their purchasing and bargaining powers. This not only served as a check against potential abuses by the powerful new distributors, it also helped facilitate McDonald's transition to larger suppliers and distributors as the cooperatives became a force in centralizing the purchasing decisions. By dealing with these cooperatives, McDonald's did not have to convince each an every individual franchisee of the benefits of frozen french fries and meat patties, or of using the total distribution concept. Importantly, their organization into cooperatives also gave the franchisees power to resist the corporation itself when it attempted to impose centralized decisions on products, suppliers, or marketing initiatives that were at odds with the collective interests of franchisees in a particular region.[20]

As should now be clear, the cornerstone of McDonald's supplier relationships is trust. As a matter of principle, Ray Kroc insisted on verbal agreements, making deals with a handshake rather than a formal contract, and this arrangement is still used today. McDonald's also insists (since 1961) on doing business with all of its major suppliers on a cost-plus basis, which effective opens its suppliers' books to scrutiny by the company. Today, these arrangements are balanced by McDonald's proven commitment to giving its suppliers a fair profit and a guarantee of future business – provided they continue to meet McDonald's service and quality requirements.[21]

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[20] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 348-352.
[21] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 346.

McDonald's is a Real Estate Company?

Having reviewed the basic relationships between the various partners in the McDonald's System – the Corporation, its franchisees, and outside suppliers – one thing should now be clear: this was not just another get-rich-quick franchising scheme that Ray Kroc had invented. In fact, during the early days, everyone in the system was making money except for Kroc's company.[22] Without big up-front fees for territorial licenses, or skimming a percentage off its suppliers, the only sources of revenue for McDonald's were a paltry franchise fee of USD 950 per unit (raised to USD 1500 in 1956) and the 1.9 percent service fee it assessed on unit sales, a quarter of which (0.5 percent) went directly to the McDonald brothers. By the late 1950s the average McDonald's store had annual sales of about USD 200,000 which resulted in an operating profit of up to USD 40,000 for the franchisee. Meanwhile, the corporation got only USD 2,800 in retainable service fees. This was hardly enough to cover to costs of minimal support to the operators, much less the extensive services Kroc was planning. In other words, his basic business model was fatally flawed.

What saved the company and turned McDonald's into a major corporate power was an ingenious financial twist devised by Harry J. Sonneborn, a former Tastee-Freez executive who was hired by Kroc in 1956 and was in effect his partner in the business over the next ten years. Sonneborn's expertise was finance, and his challenge was to find a way of making money that did not conflict with Ray Kroc's concept of fairness to suppliers and franchisees. His solution was to make money on real estate:

[22] Unless otherwise noted, the information presented in this sub-section on McDonald's involvement in real estate business is drawn from "Chapter 7, Making Money", in: Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 151-186.

Sonneborn proposed a striking simple solution. McDonald's would form a separate real estate company – called Franchise Realty Corporation – which would locate and lease restaurant sites from landowners willing to build McDonald's units, which would also be leased to the company. Franchise Realty would enter into twenty-year improved leases with these property owners and then sublease the store to the franchisee, charging a markup for the real estate services it was providing…

In his negotiations with property owners, Sonneborn refused to cave in to their demands for rents based on a fixed percentage of store sales and insisted on McDonald's paying flat monthly rents… In subleasing the store to the franchisee, he marked up McDonald's lease costs, initially by 20 percent and then by 40 percent… Futhermore, in calculating the franchisee's base rent, Sonneborn even added an interest charge on McDonald's real estate investment…

As long as the subleased store stayed in business, it would provide McDonald's with at least the 40 percent real estate margin. McDonald's real estate costs were fixed for twenty years, since there were no escalators in any of the leases Sonneborn signed. Furthermore, all subleases with franchisees were on a 'net basis', meaning that franchisees – not McDonald's – were responsible for paying property insurance and taxes, both of which were certain to increase over time…

But the best part of the formula was that the 40 percent markup on the lease was only the *minimum* rent paid by the franchisee. It would give McDonald's enough money to cover its overhead costs on servicing franchisees. Most of the profits to the company were to be made on a second feature of the rental plan, which calculated the operator's rent as a percentage of his store's sales – initially 5 percent. The operator was required to pay McDonald's either the fixed base rent or a percentage rent, whichever was higher…

> Franchise Realty also produced an immediate cash flow. As soon as McDonald's began subletting real estate to franchisees, it began requiring them to pay a $7,500 security deposit, half of which was refunded in the fifteenth year and half in the last year of a twenty-year franchise... In the meantime, McDonald's had use of the money, and within a year Sonneborn began using it to extend his real estate gambit to the second phase: ownership of the property. At first, that involved leasing the land and owning the building, using some of the deposit as a security on the ground lease and some for a down payment on the mortgage on the building. By the early 1960s, however, Sonneborn was going after total ownership, purchasing the land under a ten-year installment contract with the property owner and financing the building through a bank mortgage.[23]

Although this daring plan involved extreme leverage, Sonneborn was certain it would be lucrative if it worked. It not only complemented Ray Kroc's business philosophy by placing the company's financial interests squarely on improving the sales performance of individual units, it also helped the company attract the right kind of people as franchisees. "By franchising one store at a time, Kroc controlled the quality of operations, but the independents he attracted as licensees had neither the $30,000 then needed to acquire the one-half-acre store site nor the $40,000 needed to build the structure. Nor were most capable of borrowing those funds."[24] The ability to lower initial investment costs to a range affordable by middle-class entrepreneurs also allowed the company to award franchises only to those who made the most successful (and least troublesome) partners: individual owner/operators who were willing to restrict themselves to running a McDonald's store as their principle business activity. In the

[23] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 154-155.
[24] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 153.

early 1970s, Fred Turner (as president of McDonald's) made this an actual requirement. "Whereas previously local McDonald's franchises could be 50 percent owned by investors who did not play a direct role in the operation of the stores, Turner required that 100 percent of any new franchise be owned by a full-time operator."[25]

At a time when franchising law was in its infancy, ownership of the real estate gave McDonald's more control over a franchisee than it could not get from a franchise agreement. Unless the company retained the property rights, there was little to stop a franchisee from simply taking down the McDonald's sign, changing the name of the store (or converting it to another chain), and withholding royalty fee payments once they had gained sufficient knowledge and expertise to run the business on their own. This kind of moral hazard problem was frequently experienced by other fast-food chains (and by the McDonald brothers, prior to Kroc's involvement). A similar problem exists with regard to operating procedures and quality standards established to ensure uniformity throughout the chain and to protect the chain's brand image. Unless otherwise checked, some franchisees will become 'free-riders' who benefit from their association with the chain but fail to conform to its standards, thus jeopardizing the brand image in the longer run. Unlike early franchise agreements, leases were time-honored legal documents, and McDonald's made compliance with its operating standards one of the requirements of its lease.

Critics have argued that such agreements give the franchiser the power to expropriate a franchisee's business without just cause, and there have certainly been cases where franchisers have been found guilty of such abusive behavior. However,

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[25] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 291.

there is nothing inherently wrong with requiring compliance with standards and procedures as a condition of the franchise contract. And unlike the 'tie-in' requirements imposed by other fast-food chains (under which franchisees had to purchase equipment or supplies from the franchiser), McDonald's requirement that franchisees rent real estate from the company has withstood legal challenges. "Courts ruled that selecting and controlling locations was an integral part of running a restaurant chain and that control of that function by the franchiser was natural and did not place the franchiser's financial interest in conflict with that of its franchisees."[26] In fact, the structure of McDonald's real estate connection actually put the franchiser's financial interests in harmony with that of its franchisees, since the company made little profit from its real estate operations until its franchised stores reached higher sales volumes that caused them to pay rental rates based on a percentage of sales.

The brilliance and audacity displayed by Sonneborn in implementing his real estate plan is a story unto itself, but suffice it say that his efforts were key to McDonald's financial success, and ultimately to its dominance of the fast food market. (A booming real estate market during the 1960s and 1970s also helped, as the company's property investments grew rapidly in value). By the early 1960s McDonald's was adding one hundred new restaurants a year – more than twice as many as its largest competitors. With improved cash flow, the company was also able to increase the number of company-operated outlets. In 1960, the chain opened the first four of its so-called McOpCo (McDonald's Operating Company) units – four new company-owned and company-managed stores in Columbus, Ohio. Part of the rationale for this was a desire

[26] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 157.

to have some company-controlled outlets that could be used in training McDonald's field consultants.[27] By 1963, McOpCo had units in Chicago, Boston, Los Angeles, Atlanta, and Columbus, Ohio. Two years later, McDonald's Corporation established regional offices in all five of these cities under a sweeping reorganization plan.[28]

After its initial public stock offering in April 1965, McDonald's accelerated its expansion plans, making McOpCo the centerpiece of its new strategy. Fred Turner was convinced of the profit potential of McOpCo, but felt it needed to obtain management economies of scale by operating large clusters of units in certain markets. Since most major markets were already franchised, the only way to accomplish this was to buy out some of McDonald's largest and most successful franchisees. Beginning in late 1967, McDonald's launched a buyout program using its hot stock to provide a tax-free exchange for the operator and an acquisition bargain for the company. But the biggest deal was made for cash. It was the USD 16.8 million buyout of the premier franchise in the system: the forty-three unit Gee Gee franchise in Washington, D.C. owned by John Gibson and Oscar Goldstein. Gee Gee was also one of the few franchises that held its own property rights. (More on Gee Gee appears in the next section.) A wave of buyouts followed; from 1967 to 1976 Turner and Kroc negotiated the acquisition of 536 stores from McDonald's franchisees for a total of USD 189 million in cash and stock.[29]

In its first five years, the buyback program raised the percentage of McOpCo units from 9 to almost 33 percent of all McDonald's units. However, problems soon surfaced in attempting to run such a large number of company-owned stores, and Turner quickly

[27] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 202.
[28] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 234.
[29] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 287-291.

began to scale back on the buyout program. McOpCo was reduced from 33 to 25 percent of all units by the mid 1970s, and the company has subsequently maintained roughly this same percentage of McOpCo units (in the United States).[30] As we shall later see, however, experience running company-owned and company-operated stores was a critical factor in McDonald's successful expansion into international markets.

Is it fair to claim, as Harry Sonneborn once did, that McDonald's Corporation is actually a real estate company? Hardly so it seems, for the brilliance of his real estate plan disguised the fact that the ultimate success of the business depended on generating cash flows to pay for all those leases. Without the tremendous emphasis Kroc placed on store operations and supplier relationships, along with his desire to ensure the success of his franchisees before that of his own company, Sonneborn's real estate plan would never have gained momentum and would have looked much like other get-rich-quick franchising schemes. Moreover, as demonstrated by McDonald's buyout experience, the local knowledge and entrepreneurial energies of independent franchisees remain a critical factor in the company's success.

The McDonald's System in Summary

As should now be clear, the McDonald's System represents a philosophy as much as a business model. It is in essence how the three elements of the business – franchisees, managers and suppliers – relate to one another: how none is the other's master, and each is an entrepreneur in his own right. At its heart of the system is a dichotomous mix of conformity and creativity. On the one hand, the McDonald's System demands a strict adherence to established standards and procedures, the ultimate goal of which was

[30] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 287-291.

famously expressed by Ray Kroc as QSC&V (Quality, Service, Cleanliness and Value).[31] On the other hand, McDonald's critically depends on the diversity, individualism, and entrepreneurial spirit of independent operators as its main source of innovation.

In the introduction to his book, John F. Love summarized key elements of the McDonald's System in the following way:

> It is a federation of hundreds of independent entities connected by an intricate web of partnerships...
>
> The participants of the system have common economic incentives and a common standard of quality, service, and cleanliness. But nothing else about them is the same. Nor is there any structure to their relationship...
>
> While individuals within the system are driven by entrepreneurial self-interest, selfish interests never prevail. The entities in McDonald's are so diverse and power is so fragmented that the system has no master. A large part of the real strength of McDonald's can be attributed to the fact that the relationship between the corporation's managers, its 3,500 franchisees, and the system's 500-plus suppliers is one based on a concept of checks and balances...
>
> The history of the McDonald's System is the story of an organization that learned how to harness the power of entrepreneurs – not several but hundreds of them. It is run by decisions and policies considered to be for the common good. But the definition of *common good* is not set by a chief executive or by a management committee. Rather, it is the product of the interaction between all the players. Ray Kroc's genius was building a system that requires all of its members to follow corporate-like rules but at the same time rewards them for expressing their individual creativity.[32]

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[31] Kroc, Ray and Anderson, Robert, *Grinding it Out: The Making of McDonald's*, Contemporary Books, Chicago, 1977 and St. Martin's Paperbacks, 1987, page 91.
[32] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 7-8.

Today the McDonald's System serves as a model of industrial organization in the franchise industries, but most of what has been written about McDonald's deals only with its North American operations. Relatively little has been written on how McDonald's applied and modified its business practices for overseas expansion, especially in the non-English speaking and non-European countries. How could a system based on American notions of capitalism and entrepreneurial spirit possibly be transplanted into countries with vastly different cultures and economic systems? But transplanted it was, as shown in Table 1, into more than 120 countries around the world. The following section tells the story of how McDonald's began its international expansion.

Table 1

McDonald's Country Openings

(Asian countries shown in boldface)

Country	Date Opened
1. United States	04/15/55
2. Canada	06/01/67
3. Puerto Rico	11/10/67
4. Virgin Islands	09/04/70
5. Costa Rica	12/28/70
6. Guam	06/10/71
7. Japan	**07/20/71**
8. Netherlands	08/21/71
9. Panama	09/01/71
10. Germany	11/22/71
11. Australia	12/30/71
12. France	06/30/72
13. El Salvador	07/20/72
14. Sweden	10/27/73
15. Guatemala	06/19/74
16. Netherland Antilles	08/16/74
17. England	10/01/74
18. Hong Kong	**01/08/75**
19. Bahamas	08/04/75
20. New Zealand	06/07/76
21. Switzerland	10/20/76
22. Ireland	05/09/77
23. Austria	07/21/77
24. Belgium	03/21/78
25. Brazil	02/13/79
26. Singapore	**10/20/79**
27. Spain	03/10/81
28. Denmark	04/15/81
29. Philippines	**09/27/81**
30. Malaysia	**04/29/82**
31. Norway	11/18/83
32. Taiwan	**01/28/84**
33. Andorra	06/29/84
34. Wales	12/03/84
35. Finland	12/14/84
36. Thailand	**02/23/85**
37. Aruba	04/04/85
38. Luxembourg	07/17/85
39. Bermuda (closed)	07/24/85
40. Venezuela	08/31/85
41. Italy	10/15/85
42. Mexico	10/29/85
43. Cuba	04/24/86
44. Turkey	10/24/86
45. Argentina	11/24/86
46. Macau	**04/11/87**
47. Scotland	11/23/87
48. Yugoslavia	03/24/88
49. Korea	**03/29/88**
50. Hungary	04/30/88
51. Russia	01/31/90
52. People's Republic of China	**10/08/90**
53. Chile	11/19/90
54. Indonesia	**02/23/91**
55. Portugal	05/23/91
56. Northern Ireland	10/14/91
57. Greece	11/12/91
58. Uruguay	11/18/91
59. Martinique	12/16/91
60. Czech Republic	03/20/92
61. Guadeloupe	04/08/92
62. Poland	06/17/92
63. Monaco	11/20/92
64. Brunei	**12/12/92**
65. Morocco	12/18/92
66. Saipan	03/18/93
67. Iceland	09/03/93
68. Israel	10/14/93
69. Slovenia	12/02/93
70. Saudi Arabia	12/08/93
71. Oman	07/30/94
72. Kuwait	06/15/94
73. New Caledonia	07/26/94
74. Egypt	10/20/94
75. Trinidad	11/12/94
76. Bulgaria	12/10/94
77. Bahrain	12/15/94
78. Latvia	12/15/94
79. United Arab Emirates	12/21/94
80. Estonia	04/29/95
81. Romania	06/16/95
82. Malta	07/07/95
83. Colombia	07/14/95
84. Jamaica	09/28/95
85. Slovakia	10/13/95
86. South Africa	11/11/95
87. Qatar	12/13/95
88. St. Maarten	12/15/95
89. Honduras	12/14/95
90. Croatía	02/02/96
91. Western Samoa	03/02/96
92. Fiji	05/01/96
93. Liechtenstien	05/03/96
94. Lithuania	05/31/96
95. India	**10/13/96**
96. Peru	10/18/96
97. Jordan	11/07/96
98. Paraguay	11/21/96
99. Dominican Republic	11/30/96
100. Belarus	12/10/96
101. Tahiti	12/10/96
102. Ukraine	05/28/97
103. Cypress	06/12/97
104. Macedonia	09/06/97
105. Ecuador	10/09/97
106. Bolivia	10/23/97
107. Reunion Island	12/14/97
108. Isle of Man	12/15/97
109. Suriname	12/18/97
110. Moldavia	04/30/98
111. Nicaragua	07/11/98
112. Lebanon	09/18/98
113. Pakistan	**09/19/98**
114. Sri Lanka	**10/16/98**
115. Georgia	02/05/99
116. San Marino	07/06/99
117. Gibraltar	08/13/99
118. Azerbaijan	11/06/99
119. French Guiana	02/22/00
120. America Samoa	09/29/00

Source: McDonald's Corporation: <www.media.mcdonalds.com/secured/company/history/openings/index.html>

EARLY INTERNATIONAL EXPANSION

By the mid 1960s, McDonald's corporate executives were flush with success in the booming fast-food hamburger industry. And like other successful managers at the time, they began searching for new markets in which to work their magic. McDonald's purchased a combined restaurant and German beer garden in Chicago that proved a flop. So too did its attempts to build two other new brands for franchising: Jane Dobbing Pie Shops in southern California and Ramond's, an upscale hamburger concept with two lavishly decorated restaurants, one just off Rodeo Drive in Beverly Hills and the other near North Michigan Avenue in Chicago. More sensibly, the firm came close to buying Taco Bell and Baskin Robbins, but the deals fell through and both chains were acquired by others. McDonald's officers and directors balked at an even more outrageous scheme proposed by Ray Kroc: a new theme park project to compete with Disneyland.[33]

When Fred Turner took over as president of McDonald's in 1968, he too began looking for new ways to leverage the company's expertise in franchising and real estate development. He considered the purchase of hotels, steak houses, barbecue chains, and even florist shops as diversification options. He also entertained a proposal to buy a major stake in the Chicago Bears professional football franchise, along with two different amusement park deals. Fortunately, his final analysis in each case was that none of these businesses were as good as the one McDonald's was already in. After two years toying with various other ideas, it became obvious to Turner that McDonald's key to future success was in its existing business. The obvious answer was to look for new markets for that business, and this led to McDonald's decision to expand internationally.

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[33] Unless otherwise noted, information in this section is drawn mainly from "Chapter 17, Exporting Americana", in: Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 410-448.

Today, it is easy to forget that at the time McDonald's began its overseas expansion, it was truly a pioneering move. Almost no American retailers had dared to venture outside the country, and those that did usually limited themselves to the Canadian market. Not only was McDonald's attempting to export a uniquely American product and business concept, there was no existing model for establishing retail operations in another country. Perhaps this helps to explain why McDonald's abandoned its proven franchising methods in making its first international moves.

In 1965 McDonald's Corporation sold its first foreign license – rights to develop the Caribbean under a so-called developmental franchise – to John Gibson and Oscar Goldstein. The two were among McDonald's earliest franchisees, having signed an exclusive-territorial franchise deal in 1956 to develop the metropolitan Washington, D.C. market. Their operation, known as Gee Gee Corporation, was among the most successful in McDonald's history, in part due to the complementary talents of the two individuals. Gibson's strengths were in the finance and real estate side of the business. Significantly, the Gee Gee franchise was awarded before McDonald's entered the real estate business. While other operators were forced to rent property from McDonald's Franchise Realty after 1958, Gee Gee leased or owned all its store sites directly and paid McDonald's only the service fee of 1.9 percent of sales. Gibson obtained the financing necessary to build the business and exploit the market's potential. Goldstein, on the other hand, generated the business. His marketing acumen is legendary, and among other innovations he made extensive use of local television advertising and through it created the Ronald McDonald character.[34]

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[34] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 217-222.

On the strength of their previous performance, selecting Gibson and Goldstein to lead McDonald's first overseas move may have seemed reasonable, but in retrospect the company's choice of a developmental franchise agreement was a poor one.

> [It] meant that McDonald's provided no field supervision of the Caribbean stores, developed no real estate, and set up no suppliers. All of that was to be done by Gibson and Goldstein, and instead of charging the typical 3-percent service fee and 8.5-percent rent, McDonald's collected a mere 0.5 percent of the sales of the Caribbean stores in addition to a one-time franchise fee of $10,000 per unit. The Caribbean franchise put up some twenty-five restaurants in Puerto Rico, Panama, Nicaragua, Honduras, and El Salvador, but when Goldstein pulled back from daily involvement in the venture, it lost his operational expertise. The financially oriented Gibson was running the show, and when he ran it into the ground, McDonald's – with a stake in only 0.5 percent of the Caribbean revenues – had little incentive to pull it out of its dive.[35]

A similar situation occurred in Canada. In early 1967 two developmental franchises were sold by outgoing president Harry Sonneborn which covered the entire country. George Tidball got the rights for western Canada, while George Cohon got a license for eastern Canada. They paid only USD 7,500 to 10,000 per unit in (one-time) franchising fees and 1 percent of sales in royalties to McDonald's. This was far too little to pay for the rights to the potentially lucrative Canadian market. At least Ray Kroc thought so. When he made his first trip to eastern Canada in 1968 to dedicate the inaugural McDonald's store there, Kroc immediately offered to by back the exclusive development rights from Cohon and his partner, Ted Tannebaum, offering to pay all their debts plus USD 1 million. They refused the offer, but two years later found themselves

[35] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 417.

struggling. Their fledgling chain of 14 stores was losing USD 1 million per year and they lacked the capital necessary to develop a commanding presence in Canada. Receiving only 1 percent of sales, McDonald's had little incentive to help turn things around. Cohon was convinced Canada was as good a fast food market as the United States, but felt he had little choice but to accept the next approach made by McDonald's in 1970, selling the business in a series of deals that totaled USD 6 million. Meanwhile in western Canada, George Tidball had gotten himself caught up in a confusing array of sublicensing arrangements with investors not involved in store operations. By 1971, when he too agreed to sell out to McDonald's, his franchise had 19 stores that were losing money.[36]

All together, McDonald's paid USD 15 million to acquire a few dozen losing Canadian stores. (According to McDonald's Canada, 50 outlets were opened by 1970.[37]) Some of the company's directors were critical of these deals, and were unimpressed by the fact that McDonald's had also regained the rights to develop new outlets throughout Canada. Not so with McDonald's president, Fred Turner, who recognized that George Cohon had built a strong operations team and asked him to stay on as president of McDonald's Canada to direct an aggressive assault on the market. Critically, Turner resisted the temptation to exert headquarters control over its new subsidiary. He recognized the secret of McDonald's success in the United States was largely due to the chain's reliance on independent local operators with the freedom to develop their markets as they saw fit. He therefore gave Cohon the same leeway as an exclusive franchisee and Cohon responded by making his McDonald's operation seem as Canadian as any

[36] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 417-421.
[37] *McDonald's Canada Information Package*, February 2001, downloaded as "The McDonald's Corporate Info Kit", from <www.mcdonalds.ca/en/aboutus/index.asp>.

Canadian-owned company. He started by developing all new Canadian suppliers and conducting his company's banking only with Canadian institutions. Franchised stores, which represent half of the chain in Canada, were sold only to Canadians. Cohon even changed his own citizenship, explaining that he intended to stay in Canada and wanted the right to vote in its elections. His independence was best demonstrated in marketing. In 1971, Cohon decided to cut McDonald's prices 20 percent across the board, which resulted in a 25 percent jump in sales in one year and helped to establish the brand. When normal pricing was restored two years later, sales in Canada continued to improve. With heavy funding from its corporate parent, McDonald's Canada was the only fast-food chain to aggressively build stores in Canada during the early 1970s, and by the end of the decade, McDonald's had established a near monopoly in the local market.[38]

Based on these early experiences in Canada and the Caribbean, "Turner concluded that McDonald's Corporation had to be as heavily involved overseeing its foreign restaurants as it was in its American operations, but that type of involvement was worthwhile only if McDonald's had a lot more at risk than 1 percent of international hamburger sales."[39] He therefore scrapped the developmental licensing approach. However, he too departed from the franchising formula. Selecting the Netherlands as its next overseas target, McDonald's entered into a fifty-fifty joint venture with the country's leading supermarket chain, Albert Heijn. Although McDonald's now had a major equity stake, it was in partnership with a corporation rather than an individual – the only kind of partner it would consider in the United States. While the idea was to use

[38] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 417-421.
[39] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 417-417.

Heijn's expertise in setting up food suppliers in Europe, it left the company without a local entrepreneur running the stores. There were other blunders as well:

> Turner also ignored the chief management lesson that McDonald's had learned in the United States – that operations-oriented hamburger chains are best built by operations-oriented managers who are promoted through the ranks. While McDonald's new president was placing operations specialists into every other line position, he hired an outsider to implement the corporate plan to develop the foreign market...many of the early mistakes McDonald's made abroad can be attributed to the fact that the consultant it hired had no background in McDonald's operations and thus little appreciation for the subtleties of its fast-food system.[40]

Another mistake was to follow American experience and build stores in the suburbs, when all the retail action was in urban areas (the central cities in Europe had not deteriorated as they had in America, and the suburbs were generally devoid of commercial development). The company was also spooked into thinking it had to serve indigenous foods, eliminating the popular Quarter Pounder from its menu in favor of applesauce and deep-fried chicken croquettes. In the end, a series of small mistakes turned the Netherlands experiment into a long-term disaster. It took years for the Dutch stores to overcome those early blunders, even after McDonald's bought out the Heijn interest in 1975.[41]

The results of these early experiences, all of which involved significant departures from McDonald's proven business practices in the United States, led the company to take a different approach when it entered the Japanese market. Learning from its mistakes,

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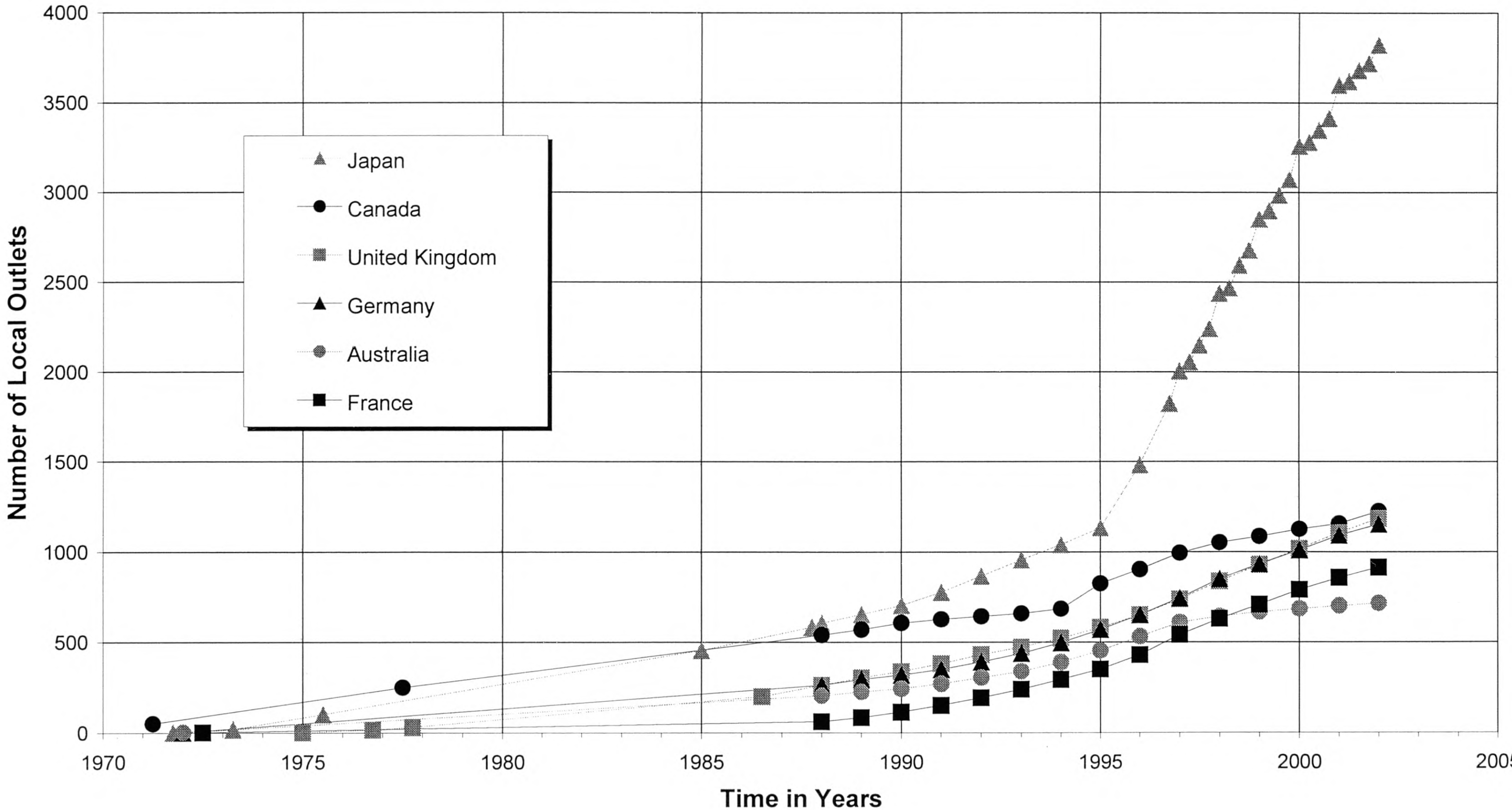
[40] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 418.
[41] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 418.

McDonald's stuck more closely to the principles and philosophies that made it successful in America. Chief among these was to place their faith an individual's local knowledge and entrepreneurial spirit. As it turned out, McDonald's made the right choice. Although somewhat more populous than McDonald's other 'big six' international markets, Japan is also more distant from America – both geographically and culturally – which makes the company's success there all the more remarkable. As shown in Figure 2, McDonald's unit growth in Japan has actually accelerated in the past decade, and today it ranks second only to the United States in terms of the number of McDonald's outlets. It is also the first foreign McDonald's operation to go public.

Had McDonald's venture in Japan proved unsuccessful, it is questionable whether and when McDonald's would have dared to attempt expansion elsewhere in Asia. For this reason alone, it is valuable to examine McDonald's Japan experience in some detail. Another reason is that McDonald's success in Japan compelled the company to follow a similar strategy, at least in terms of its industrial organization, as it entered other Asian markets. The following section therefore describes the development of McDonald's Japan, from the opening of its first store in 1971 to the recent retirement of its founder. Subsequent sections cover McDonald's experience in each of the other Asian countries.

Figure 2
McDonald's Growth in the 'Big Six' International Markets



JAPAN

McDonald's began its operations in Asia with a 1971 entry into Japan. It was part of the then 1700-unit chain's first wave of overseas expansion. In a critical decision that characterizes the company's formula for success throughout the region, McDonald's Corporation selected a well-connected individual having prior (but unrelated) business experience as its joint-venture partner in Japan. Den Fujita was a 1951 law graduate of Tokyo University who as a student, at the age of 25, started what became a successful import-export business, specializing in shoes, handbags, and apparel.[1] Through his trading representative in Chicago, Fujita had learned that McDonald's Corporation was interested in international expansion. Already familiar with the popularity of American fast food from his many business trips to the United States, Fujita was convinced the time was right to introduce McDonald's to Japan.

Fujita's pursued the opportunity, and soon his entrepreneurial zeal and fluency in English won the confidence of McDonald's founder Ray Kroc and president Fred Turner. The parties agreed to form a Japanese joint venture, with McDonald's Corporation owning 50 percent and the rest being split between Den Fujita, through his Fujita & Company Limited, and Daiichiya Banking Company.[2] McDonald's Company (Japan) Limited was formally established in May 1971, with Fujita as its president and chief executive officer.[3] Not long thereafter, Den Fujita bought out Daiichiya's interest (which was probably only intended as a loan guarantee).[4]

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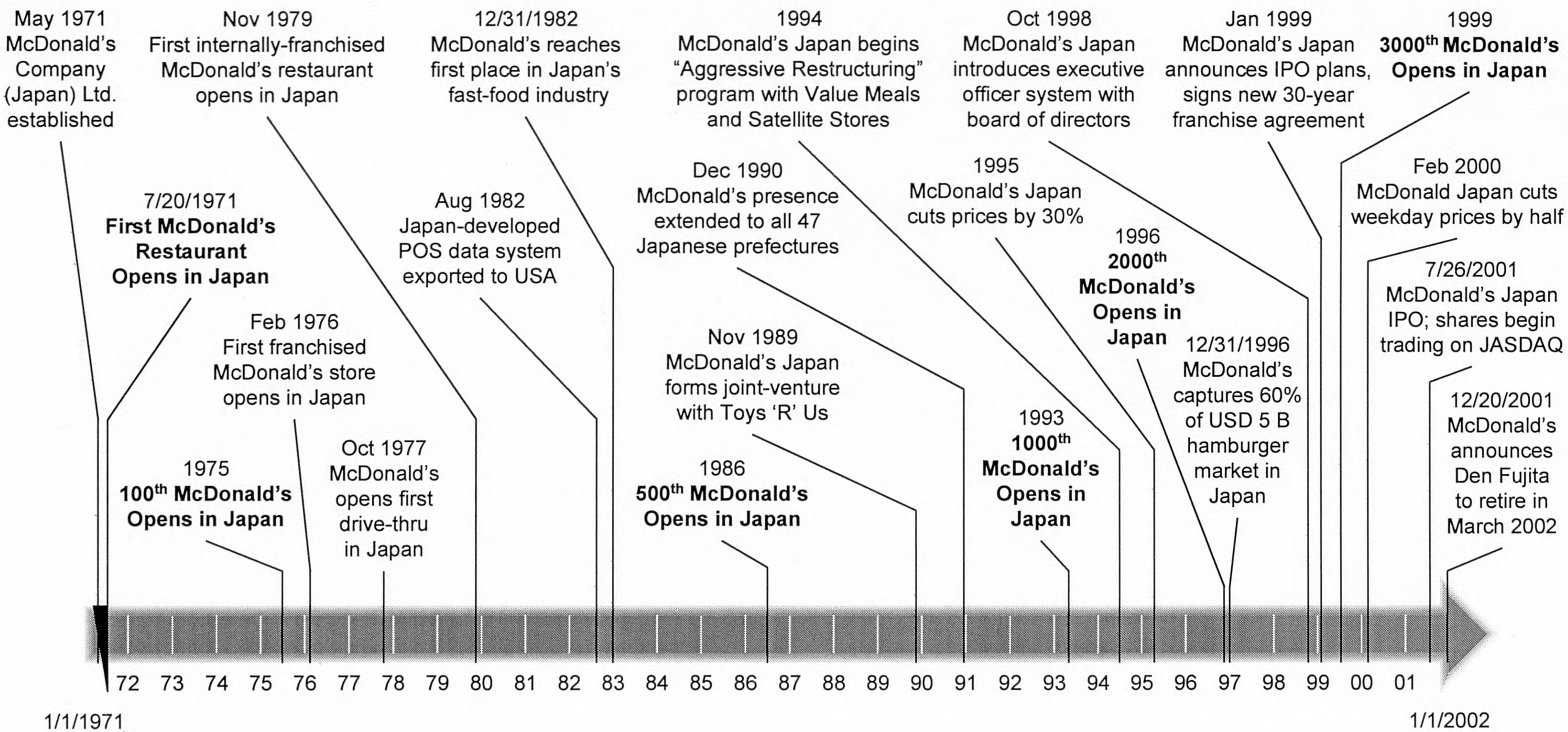
[1] Anonymous, "The Stars of Asia – Managers: Den Fujita, President, McDonald's (Japan)", *Business Week*, 2 July 2001.
[2] Love, John F., *McDonalds: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 422-423.
[3] McDonald's Company (Japan) Ltd., "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.
[4] Love, John F., *McDonalds: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 422-423.

Figure 3
McDonald's in Japan Timeline



The Early Years

From the beginning, Fujita insisted that McDonald's Japan should be run as a Japanese entity, autonomous from McDonald's headquarters in Oak Brook. He believed American fast food could be successful in a Japanese culture seeking to identify with the success of the West, but the company attempting to sell it must look 100 percent Japanese. In short, the hamburger should not be positioned as an American import. Such independence also proved critical to the development of Fujita's marketing strategy, which differed considerably from that followed by McDonalds in America.

Den Fujita was convinced he could sell a concept as foreign as the hamburger in a culture whose diet was oriented to fish and rice, and insisted that there was no need to tailor McDonald's menu to Japanese tastes. He believed success in Japan depended on establishing a high-quality, up-scale image for the McDonald's brand, and its restaurants should be positioned as a luxury experience rather than cheap fast food. He began by promoting hamburgers as a 'revolutionary' new product, giving lectures on it at universities and revealing his plans to put hamburger outlets throughout Japan. He arranged for the government to adopt his (i.e. McDonald's) specifications and to apply its Japanese Agricultural Standard to hamburger, which was previously a suspect commodity among the Japanese. He also convinced officials to create a Grade A classification so McDonald's could boast of the 'highest' beef quality.[5] Fujita ignored McDonald's advice to begin building his stores in the suburbs, and insisted that the first McDonald's unit in Japan must be located in the Ginza, an international shopping bazaar in downtown Tokyo – it was the place where all new imported products get their initial

[5] Martin, Richard, "McDonald's Co. Japan Ltd.: A knack for timing and resourcefulness makes McD's successful overseas", *Nation's Restaurant News*, 26 January 1998.

exposure.[6] In addition, he felt the suburban drive-in concept was inappropriate for Japan, at least initially. Finally, he registered 'Makudonarudo' as the local brand name for McDonald's, partly to mask its American identity and partly because it is easier for Japanese speakers to pronounce.[7]

Figure 4
McDonald's in the Ginza

(photo taken in August 1971)

The first McDonald's store in Japan was opened on 20 July 1971. Just two days before, the inaugural site was a street-corner show window and the purse department of the prestigious Mitsukoshi department store (Figure 4). Through contacts at Mitsukoshi, to whom he had supplied purses, Fujita acquired 500 square feet of ground-floor space.

[6] Love, John F., *McDonalds: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, page 423.
[7] Martin, Richard, "McDonald's Co. Japan Ltd.: A knack for timing and resourcefulness makes McD's successful overseas", *Nation's Restaurant News*, 26 January 1998.

Although open to the street, the space was only one-fifth the size of a typical McDonald's store. Fujita made it work by designing a compact kitchen and by using stand-up customer counters instead of seats. He also agreed not to interrupt Mitsukoshi's business, which regularly closed only from 6:00 PM Sunday to 9:00 AM Tuesday. He deployed 70 builders who were trained during three full-scale rehearsals in a rented warehouse to construct, equip, and stock the restaurant within 36 hours. To the amazement of visiting McDonald's officials from America, the store actually opened on schedule and rang up $3,000 during its first day. Within a few months it set a new McDonald's record with a one-day volume of $6,000.[8]

The expansion program that followed was equally amazing. A month before his first store opened, Fujita established a Hamburger University in Japan to train store managers and assembled a staff of twenty headquarters people to supervise an expansion program. Just three days after the first store debuted, a second store was opened in Shinjuku-ku, near one of Tokyo's commuter train terminals. One day later, a third unit was opened. After only eighteen months, Fujita's team was operating 19 McDonald's restaurants throughout Japan, virtually all located in urban centers – and each succeeding by marketing only standard McDonald's fare.[9] Within four years McDonald's Japan had broken even and was within months of achieving its goal of 100 operating units.[10] [11]

A keen understanding of the local market was critical to McDonald's success in Japan, but sound operations management was equally important. Fujita was given

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[8] Love, John F., *McDonalds: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 424-425.
[9] *Ibid.*
[10] do Rosario, Louise, "Next: Sushi Burgers", *Far Eastern Economic Review*, Volume 155, Issue 15, Hong Kong, 16 April 1992.
[11] Martin, Richard, "McDonald's Co. Japan Ltd.: A knack for timing and resourcefulness makes McD's successful overseas", *Nation's Restaurant News*, 26 January 1998.

enormous freedom in marketing decisions, but McDonald's would not allow him to deviate from its proven operating principles. Getting Japanese managers and employees to follow McDonald's excruciatingly detailed procedures manuals was not difficult. In fact, their strict adherence to procedure actually threatened to create other problems.

In some respects, Japanese management culture was too regimented for McDonald's system. It stifled the initiative of individual store managers, a key to McDonald's grass-roots creativity, and threatened to do the same to its management team. To address this potential problem, McDonald's assigned one of its own managers to Fujita's team. From the beginning, John Asahara, a Japanese-American, served as operations manager, responsible for introducing the American management techniques that McDonald's had found critical to its success. With Fujita's blessing, Asahara built a young and creative operations team, which he sheltered from the potentially stifling influences of Japanese management culture, in which most power rests with more traditional senior executives. When operations decisions at McDonald's Japan ran counter to top management desires, it was Asahara who took the heat. Asahara also challenged the Japanese tradition of promotion strictly by seniority, and encouraged the promotion of young, aggressive operations managers ahead of more senior staffers. He even convinced the Japanese company of the wisdom of using part-time assistant managers, a concept foreign to the Japanese. Most important, Asahara did not simply communicate the dictates of the American partner, but rather he accomplished everything by patiently teaching that American operating concepts – at least as regards fast food – produced an efficiency that the Japanese respected.[12]

[12] Love, John F., *McDonalds: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, pages 426-427.

McDonald's later sent various other executives to Japan, including a corporate marketing director, to address specific needs and develop new expertise in the local management team.[13] In some cases, traditional American marketing concepts were adopted, such as when McDonald's Japan opened its first drive-thru store in October 1977.[14] However, McDonald's experience also shows that cross-cultural learning is a two way street, as several innovations developed in Japan have contributed to company success elsewhere in the world. Over time, McDonald's Japanese menu development team began introducing new products to better suit local tastes, including the highly successful Teriyaki McBurger and Chicken Tatsuta, several of which were subsequently introduced by McDonald's in other Asian markets with great success.[15] Fujita's team was also credited with operational innovations, including its work with Panasonic Corporation to develop a standardized electronic point-of-sale (POS) system that was eventually exported from Japan to McDonald's Corporation in the United States in August 1982, and to outlets worldwide.[16] [17]

As McDonald's Japan expanded operations to locations outside the major urban centers of Honshu Island, it began to employ alternative forms of business organization. In February 1976, the first franchised McDonald's restaurant was opened in Urasoe, Okinawa. A few years later, the company launched an internal franchising system, under which certain qualified, long-term McDonald's Japan employees could become eligible to operate their own franchised restaurants. The first internal-franchised store opened in

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[13] Martin, Richard, "McDonald's Co. Japan Ltd.: A knack for timing and resourcefulness makes McD's successful overseas", *Nation's Restaurant News*, 26 January 1998.
[14] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.
[15] Martin, Richard, "McDonald's Co. Japan Ltd.: A knack for timing and resourcefulness makes McD's successful overseas", *Nation's Restaurant News*, 26 January 1998.
[16] *Ibid.*
[17] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.

Saitama Prefecture in November 1979.[18] This policy no doubt helped keep experienced managers from leaving McDonald's Japan to pursue entrepreneurial opportunities with competing food service companies. However, franchising remained a minor factor in the early development of McDonald's chain in Japan.

The innovative strategies and tactics employed by McDonald's Japan throughout its first decade had obviously worked. By the end of 1982, McDonald's gained the number one ranking in Japan's food service industry, based on annual sales of JPY 70.2 billion.[19] It is a position the company has retained ever since.[20]

Expansion in the Boom Years

By the early 1980s, Den Fujita had not only made a success of McDonald's in Japan, he had also demonstrated the tremendous growth potential of the quick service restaurant industry in that country. The economy in Japan was booming, and its consumers seemed eager to try all things Western. It was now becoming important to defend McDonald's position against new competitors (both domestic and international) seeking a portion of the Japanese fast-food market.

McDonald's Japan continued its steady expansion throughout the 1980s. By the close of 1984, the chain had 455 outlets in Japan, and sales for that year topped JPY 100 billion.[21] Three years later (at the end of 1987), the number of outlets had risen to 604, major urban centers, but extended to nearly all parts of Japan. By December 1990, when the first McDonald's outlet in Yamagata Prefecture opened, the firm could boast it had at

[18] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.
[19] *Ibid.*
[20] Kubota, Coco, "Suiting the palate and the pocketbook", *Journal of Commerce*, Volume 408, Number 28,731, 24 May 1996, page 1A.
[21] Moskowitz, Milton, "The money tree: The world's largest restaurant business", *The San Francisco Chronicle*, 14 June 1985, page 38.

least one store each of Japan's 47 prefectures.[22] After two decades of operation (at the end of December 1991), McDonald's Company (Japan) Limited had a chain of 865 outlets, and its annual sales of JPY 207.8 billion made it one of the largest private companies in Japan.

As McDonald's Japan entered the 1990s, Den Fujita faced several new challenges. He was clearly committed to a long-term policy of rapid unit growth, both to gain additional market share and to grow the market by extending McDonald's geographic coverage. In April 1992, McDonald's Japan announced plans for 11 percent annual growth, and projected that its sales would reach JPY 300 billion by 1994.[23] Rapid growth meant that Fujita & Company Limited and Den Fujita personally was often required to guarantee some obligations and leases for new restaurants. Through 1977, Fujita & Company Limited had guaranteed nearly JPY 7 billion worth of obligations, and as of 1993, it still had outstanding guarantees totaling over JPY 3.7 billion for 61 restaurant sites.[24]

Financial analysts claimed McDonald's Japan's aggressive expansion plans could not be easily achieved without an infusion of outside capital. Moreover, Den Fujita had ambitious plans for other business ventures that would also require considerable capital. In November 1989, he teamed McDonald's Japan (as a 20 percent joint-venture partner) with Toys 'R' Us for the purpose of setting up a toy chain in Japan, and committed to open at least 11 outlets within two years. Then in March 1991, he set up a joint venture between Fujita Shoten and Blockbuster Entertainment to start a video-rental franchise

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[22] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.
[23] do Rosario, Louise, "Next: Sushi Burgers", *Far Eastern Economic Review*, Volume 155, Issue 15, Hong Kong, 16 April 1992.
[24] Martin, Richard, "McDonald's Co. Japan Ltd.: A knack for timing and resourcefulness makes McD's successful overseas", Nation's Restaurant News", 26 January 1998.

business with a target of 1000 outlets nationwide before the turn of the century. Brokers noted that McDonald's should have gone public in the early 1980s when then fast-food business was still a young industry with few major players. They pointed to the success of Japan Kentucky Fried Chicken, which had gone public as recently as August 1990. Its IPO was oversubscribed and boosted the price of other listed restaurants.[25]

Despite the conventional wisdom, Den Fujita not only denied reports that McDonald's Japan was considering a public share offering, but declared that as long as he lived he would never let the company go public. This was in April 1992, when he still controlled 50 percent of the McDonald's Japan joint venture through his personal 10 percent stake in the company and a 40 percent stake held by Fujita Shoten, his 70-percent owned investment holding company.[26] (Fujita family members, including two sons, were believed to be among other shareholders in Fujita Shoten.)

McDonald's Japan continued to expand throughout the early 1990s without going public. From December 1991 to December 1994 the chain increased from 865 to 1169 outlets. Thus the company met its objective of achieving an 11 percent average annual growth rate. However, it fell short of meeting its companion goal of reaching JPY 300 billion in annual sales. In fact, despite rapid unit growth, system-wide sales stagnated after 1991, as shown in Table 2.

Some observers though McDonald's had finally achieved market saturation in Japan, and that any further expansion would inevitably lead to diminishing returns. However, it was not quite that simple. The retail landscape in Japan had changed with the growing presence of convenience stores and a greater variety of prepared foods

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[25] do Rosario, Louise, "Next: Sushi Burgers", *Far Eastern Economic Review*, Volume 155, Issue 15, Hong Kong, 16 April 1992.
[26] *Ibid.*

available to consumers. Dining out was no longer a new and growing phenomenon, and Japan's food service industry experienced declining annual growth rates (of just a few percent) through most of the 1990s.[27]. Western-style quick service restaurants had lost some of their novelty, but Japan's population growth had also reached a plateau, and the potential for market expansion no longer seemed limitless. However, the most immediate problem affecting McDonald's sales in Japan (along with others in the food service industry) was a sluggish economy that discouraged consumer spending.

Table 2
McDonald's Japan Performance in the Early 1990s

Year	Total* Outlets	Outlet Growth Over Prior Year	System-wide Sales JPY (billions)	Sales per Outlet** JPY (millions)
1991	865	11.5 %	207.8	253.2
1992	956	10.5 %	212.0	232.9
1993	1040	8.8 %	212.1	212.5
1994	1169	12.4 %	215.3	194.9

* total number of outlets in operation as of 31 December of each year.
** based on the average number of outlets in operation during the year.
source: McDonald's Company (Japan) Ltd.

By 1994 the Japanese economy was clearly in trouble, and consumers were becoming more pessimistic about the prospects for recovery. The Nikkei 225 stock index, which reached an all-time high of nearly 39,000 during the last week of 1989, fell dramatically in the first nine months of 1990 to a level below 21,000. After a brief recovery in late 1990, the slide resumed in early 1991 and the Nikkei continued steadily downward until it stabilized below 17,000 for a few weeks in January 1993. Throughout

[27] According to market research by McDonald's Japan, growth rates in the Japanese food service market declined from about 7 percent in 1991 to almost zero in 1994; they increased slightly in 1995 and 1996 (to nearly 4 percent), then declined again, reaching negative values in 1999 and 2000. Source: McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.

1993 and early 1994 the market remained fairly flat, with an average value of less than 20,000. Then in late 1994, the Nikkei once again went into a decline, and it dropped below 15,000 in June 1995 before the trend reversed. One factor contributing to this latest market decline was a sharp appreciation in the value of the Japanese Yen. The value of the Yen had been slowly creeping up in the early 1990s, from JPY 145 (USD exchange rate) in January 1990 to JPY 111 in January 1994. However, in the first six months of 1994 it gained more than 13 percent against the U.S. Dollar, reaching JPY 98 in July 1994. Just a year later the exchange rate was JPY 87 = USD 1. Throughout the 1980s the Japanese economy (measured in terms of GDP) grew at an average annual rate of 4.0 percent, but during the 1990s, it achieved an average growth rate of just 1.3 percent. Japan's boom was over.

Aggressive Restructuring

McDonald's Japan responded to these changing economic and market conditions with a new package of innovative product and store strategies aimed squarely at improving customer satisfaction. These "Aggressive Restructuring" measures began in 1994, and consisted of two parts. The first was a Market Area Strategy, which shifted the target from large prime-location restaurants to dispersed locations to achieve greater customer convenience. The second was a Value Strategy, which introduced significant price revisions resulting in everyday low prices.[28]

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[28] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>. Note: Considering this source, and the apparent lack of any prior public reference to "Aggressive Restructuring" or its component Market Area and Value Strategies, it seems reasonable to conclude that these ideas actually began in the mid 1990s as separate (and perhaps even experimental) initiatives, and that they were later, after proven to be successful, incorporated into an overarching corporate growth strategy. Presenting them *a posteriori* as a coherent, forward-looking, and ultimately successful strategy developed over six years earlier would certainly be appealing to potential investors interested in McDonald's 2001 initial public share offering in Japan.

One part of the Market Area strategy was the development of standardized store designs appropriately scaled for different market areas. For example, the 70 series was intended for large stores in downtown areas or along major roads; the 50/40/30 series were intended for local area stores and smaller towns. Standardized store and equipment designs, together with modular construction techniques, both reduced initial investments and lowered operating costs.[29] Optimal siting of new stores to maximize geographic coverage and avoid cannibalizing sales of existing stores also became a priority, and McDonald's Japan employed the latest technology in its store location feasibility studies (predictably named McGIS, or McDonald's Geographical Information System). Another aspect of the Market Area strategy was the development of satellite stores that require a smaller initial capital investment and are designed to minimize operating costs.

Den Fujita had previously displayed his real-estate savvy by developing a small, urban 'in-store' or in-line restaurant format. It accommodated Japan's building density (and associated high real estate prices), by having fewer seats and one or two fewer menu items.[30] It also fit well with the Japanese perception that McDonald's fast food is more of a snack than a proper meal, and thus competes with traditional non-rice fast foods, such as udon and soba noodles, which are often sold out of smaller street-side shops with only limited seating. (Perhaps this was an indirect result of Fujita's initial positioning of the hamburger, since other newly introduced non-rice fast foods, such as pizza and fried chicken, are considered by Japanese as meals rather than snacks.)[31]

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[29] McDonald's Corporation had previously employed standard store designs and prefabricated store construction techniques in several other countries, so this was not an innovation unique to Japan.
[30] Martin, Richard, "McDonald's Co. Japan Ltd.: A knack for timing and resourcefulness makes McD's successful overseas", Nation's Restaurant News", 26 January 1998.
[31] Ohnuki-Tierney, Emiko, "McDonald's in Japan: Changing Manners and Etiquette", Chapter 5 in *Golden Arches East: McDonald's in East Asia*, edited by James L. Watson, Stanford University Press, Stanford, California, 1997, pages 163-169.

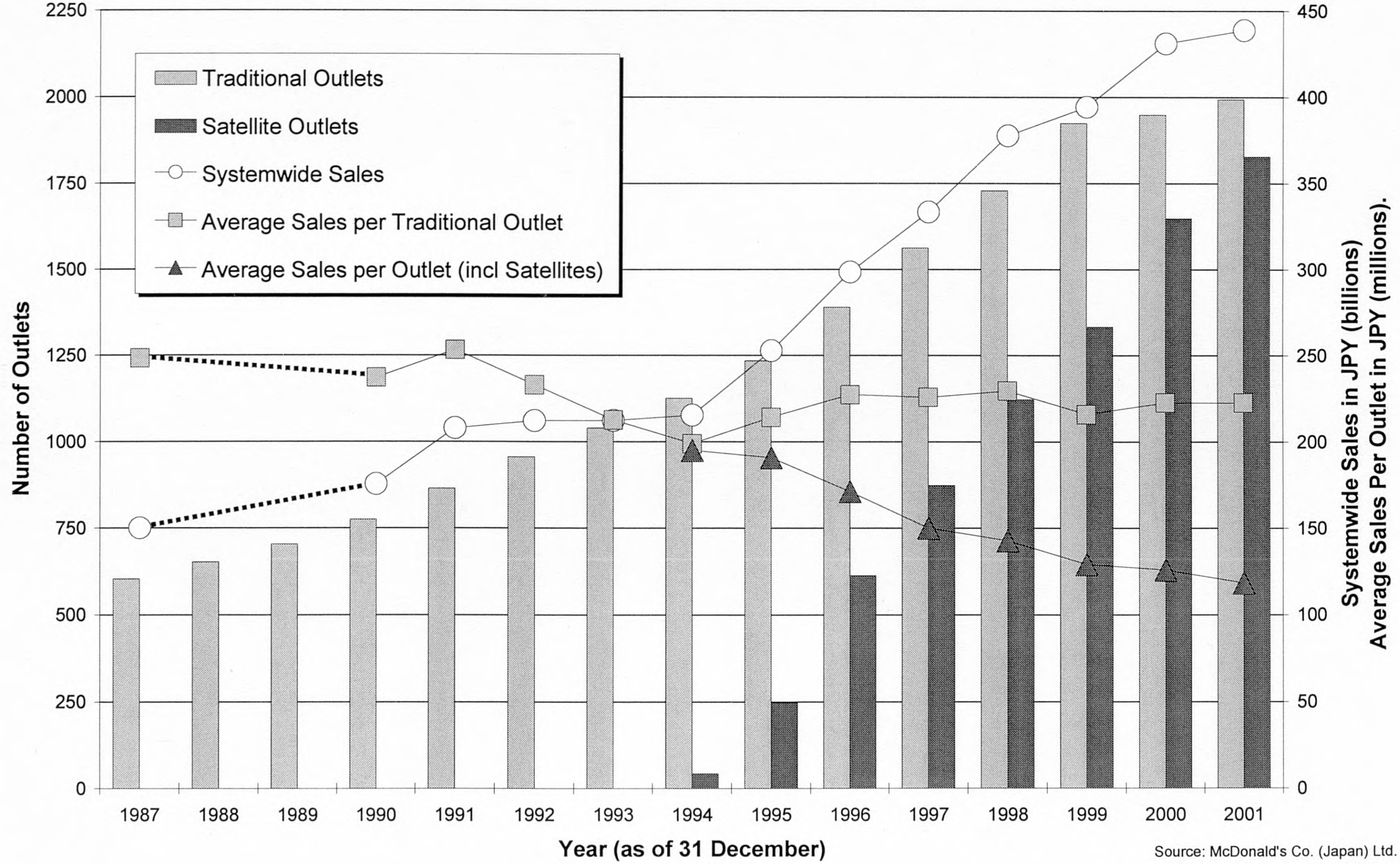
Beginning in 1994, this experience was used in developing the satellite concept. Satellite stores are simply built and operate with a minimum workforce, which allows them to be opened in locations with limited operating hours or other restrictions, such as school campuses, factories, hospitals, and shopping malls. For efficient operation of the satellite stores, McDonald's forms alliances with businesses other parties having commercial or public facilities with high customer-gathering potential.[32] Details of the alliance agreements are not known, but most likely involve either a fixed rental fee or sales-based royalty (or some combination of these) paid to the alliance partner. (These alliance partnerships are distinct and separate from external corporate franchises, as discussed below.) Each satellite store is affiliated with a nearby mother store, and extends its coverage into niche areas that cannot be fully served by the traditional store. Satellites offer a limited menu for simplified operation and are staffed solely by part-time employees, under the leadership of a manger from the mother store. They also share certain equipment and inventories with the mother store for greater cost efficiency.[33]

Although McDonald's Japan has continued to build traditional stores at nearly the same rate as before, most of its unit expansion since 1994 has been in the form of satellite stores. As shown in Figure 5, satellite stores accounted for nearly half of McDonald's outlets in Japan by the end of 2000. Over 80 percent of these satellites are located within major retailers' shopping center or stand-alone stores.[34]

Figure 5 also shows a rapid increase in system-wide sales after 1994 that coincides with the development of satellite stores. However, gross sales figures do not

[32] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.
[33] Although McDonald's Corporation has employed the satellite concept in several other countries, it has been most extensively used in Japan, Canada, and Brazil.
[34] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.

Figure 5
McDonald's Japan Unit Growth and Sales by Outlet Type



Source: McDonald's Co. (Japan) Ltd.

reveal the whole story. As one might expect, average sales of all units (including satellite stores) steadily decreased as the proportion of satellites increased.[35] Of course, such a decline in average sales per outlet was to be expected, given the limited scale and scope of the satellites (which, it must be remembered, are justified on the basis of their lower investment and operating costs). However, the average sales per traditional outlet did not exhibit a corresponding increase.[36] Since each satellite is affiliated with a mother store (a traditional outlet), one would expect higher total sales at traditional outlets with satellites. Thus on average, system-wide sales per traditional outlet should increase in proportion to the increasing number of satellite stores in the late 1990s. The fact this did not happen (as shown in Figure 5) would seem to raise some questions about the cost-effectiveness of the satellite concept. However, there is another dynamic that confuses this analysis: a lower-pricing strategy that was also implemented during this period.

As the central feature in what was later called its Value Strategy, McDonald's Japan adopted a more aggressive pricing policy beginning in 1994 with the introduction of new value meals. When the Japanese Yen appreciated sharply in early 1995, McDonald's responded by lowering prices 30 percent for eight major products and launching a promotional campaign claiming it was passing benefits on to Japanese consumers. The price of a hamburger dropped from JPY 210 to JPY 130, and almost immediately the company saw its sales increase by 20 percent. A value meal consisting

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[35] Average annual sales per outlet was calculated by dividing system-wide sales for the year by the average number of outlets (of all types) in operation during that year. The latter value was estimated by adding the total number of outlets at the end of the year to the total number of outlets at the start of the year (the end of the previous year) and dividing the sum by two. In this case, no distinction is made between traditional and satellite outlets.

[36] Average annual sales per traditional outlet was calculated by dividing the system-wide sales for the year by the average number of traditional outlets in operation during that year (excluding from consideration satellite stores).

of a hamburger, fries, and a Coke now cost the equivalent of just $3.33, compared with $4.08 for a similar meal at MOS Burger, McDonald's principle local competitor.[37] With such a positive response, the price cuts were made permanent. Then in the summer of 1996, McDonald's Japan cut its hamburger price to JPY 80 for a limited-time promotion. The move met with similar success, and eventually this lower-price strategy forced several other companies to stop selling hamburgers.[38]

Along with the introduction of satellite stores, the low-price strategy boosted sales by 17.5 percent to JPY 253 billion in 1995, from JPY 216 billion in the previous year.[39] This fell short of the JPY 300 billion sales goal McDonald's had set in early 1992, but it still represented solid performance in difficult economic times and improved the company's competitive position in the market. By the end of 1996, McDonald's Japan had captured more than 60 percent of the USD 5 billion hamburger market, and its sales represented one percent of all restaurant spending in Japan. McDonald's also accounted for more than five percent of the total beef consumption in Japan (and as much as ten percent by one account).[40][41]

As the recession continued, McDonald's Japan again cut its hamburger price, this time by half (to JPY 80), for a special two-week summer promotion in 1998. Total sales rose 30 percent over the same period in the previous year. As one McDonald's official explained, "Through research we established what price point the consumer wanted, then

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[37] Lev, Michael A., "In Japan, McDonald's means great marketing", *Chicago Tribune*, 25 February 1997.
[38] Anonymous, "McDonald's price cuts give its competitors heartburn", *Nikkei Weekly*, Volume 34, Number 1736, 19 August 1996, page 10.
[39] Kubota, Coco, "Suiting the palate and the pocketbook", *Journal of Commerce*, Volume 408, Number 28,731, 24 May 1996, page 1A.
[40] Withiam, Glenn, "McDonald's: Hamburger purveyor to the world", *Cornell Hotel and Restaurant Administration Quarterly*, Ithaca, Volume 38, Issue 3, June 1997.
[41] Lev, Michael A., "In Japan, McDonald's means great marketing", *Chicago Tribune*, 25 February 1997.

worked backward to see how we could deliver this and make a profit. This type of pricing philosophy has never been implemented in Japan in any industry."[42]

More important, other hamburger operators in Japan had neither the volume nor global purchasing power to compete with McDonald's in a price war. As Jeff Schnack, president of 3Rock Limited, a Tokyo-based food service consulting company, observed in early 1999, "Only McDonald's can do that type of discounting...Everyone is trying to match them and flowing red ink."[43] McDonald's purchasing power in Japan is truly enormous. Each year the company buys more than JPY 100 billion in food materials, including 40,000 tons of beef and 110,000 tons of potatoes. Its supply network consists of about 100 domestic companies with 150 local factories in Japan, plus another 20 or so overseas suppliers. McDonald's offshore procurement ratio is approximately 20 percent, but with foreign exchange transactions amounting to nearly JPY 18 billion annually, it is in a favorable position to get good hedging rates to protect against currency swings. Most supplies are delivered to the individual stores from one of 13 distribution centers operated by Fuji Echo Company Ltd., McDonald's logistics contractor in Japan.[44] In addition to reducing costs through its procurement system, McDonald's Japan had made extensive use of part-time workers to reduce its labor costs. With 1,949 traditional and 1649 satellite outlets in operation at the end 2000, there were just 4,319 full-time store employees. Part-time workers (numbering over 100,000) accounted for 95.9 percent of all employees – well above the average among restaurant operators in Japan.[45]

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[42] Brent, Elizabeth, "Japan's deep recession spells big change for branches of US brands", *Nation's Restaurant News*, Volume 33, Number 7, 15 February 1999, page 31.
[43] *Ibid.*
[44] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.
[45] *Ibid.*

On 24 February 2000, McDonald's did it again with its Weekday Smile promotion, this time halving the prices of its mainstay burgers on weekdays. At just JPY 65 for a hamburger (JPY 80 for a cheeseburger), McDonald's price was one-third that of its main rival, Mos Burger, and half the price at the number three chain, Lotteria.[46] This led to a 4.8 fold jump in annual sales for these products on weekdays, and the company found a new market: the cost-conscious businessmen seeking a quick lunch.[47] [48] After a year, McDonald's had another reason to smile: the master franchise holder for Burger King in Japan finally called it quits. In February 2001, Japan Tobacco announced it was selling its 25 Burger King outlets in Tokyo to a local fast food chain, Lotteria, which planned to convert them. Japan Tobacco cited poor earnings as the reason for giving up on Burger King after just five years. (Another seven Burger King restaurants run by an affiliate of Seibu Railway Company Limited outside Tokyo remained open.)[49] This gave McDonald's a 65 percent share of the hamburger market in Japan, and left Wendy's as the only other international hamburger chain still operating there.[50]

Through its competitive pricing policies, McDonald's had strengthened its competitive position in the Japanese market, but at what cost? According to one recent report, the price of McDonald's cheapest burger had dropped 70 percent since 1995, while production costs were down just 25 percent.[51] Had lower pricing hurt the company's profitability? Den Fujita seemed to discount this possibility, saying in March 2001 that McDonald's Japan might cut prices even further, depending on foreign

[46] Takai, Yukiko, "McDonald's Japan sells Big Macs cheap, not shares", *Bloomberg*, 11 July 2001.
[47] Anonymous, "McDonald's Japan unit to go public", *The Malay Mail*, Malaysia, 1 March 2001, page 27.
[48] Anonymous, "The Stars of Asia – Managers: Den Fujita, President, McDonald's (Japan)", *Business Week*, 2 July 2001.
[49] Anonymous, "JT to sell Burger King outlets to Lotteria", *Kyodo News*, Japan, 2 February 2001.
[50] Dawson, Chester, "A tall order for McDonald's Japan", *Business Week*, 16 July 2001.
[51] Dawson, Chester, "A tall order for McDonald's Japan", *Business Week*, 16 July 2001.

exchange rates. If the Yen were to reach JPY 90 (per U.S. Dollar; it was then about JPY 120), McDonald's hamburger prices would fall to JPY 45 from the current weekday price of JPY 65.[52] This provided another clue to the logic of McDonald's low-pricing strategy. The value of sandwich sales to total sales at McDonald's outlets in Japan had remained nearly constant (it was 39.5 percent in 1996, and 39.3 percent in 2000), despite several price cuts on hamburger products.[53] Thus the company was selling more burgers, relative to drinks, fries, and desserts (the prices of which had not changed), than it did before the cuts. However, burgers have a higher component of foreign inputs, namely beef and cheese, so when the Japanese Yen strengthens, the cost of producing hamburgers actually decreases (while the cost of other menu items is relatively unaffected by currency exchange rates). If a drop in hamburger prices leads to an increase in sales for all menu items, as appears to be the case, the company benefits in two ways from a stronger Yen. As evidence of this theory, Figure 6 shows that both of McDonald's large, permanent price cuts (in April 1995 and February 2000) were implemented following a large decline in the value of the Japanese Yen.

Even if pricing was not a problem, many people questioned the wisdom of McDonald's continued rapid expansion in Japan, especially after Den Fujita said in 1997 that McDonald's Japan expected to reach 10,000 outlets by 2007.[54] The company had already greatly exceeded Ray Kroc's vision for success in Japan, which called for opening just 500 outlets within thirty years. Being a private company, McDonald's Japan published few details about its financial performance, leading outsiders to speculate about

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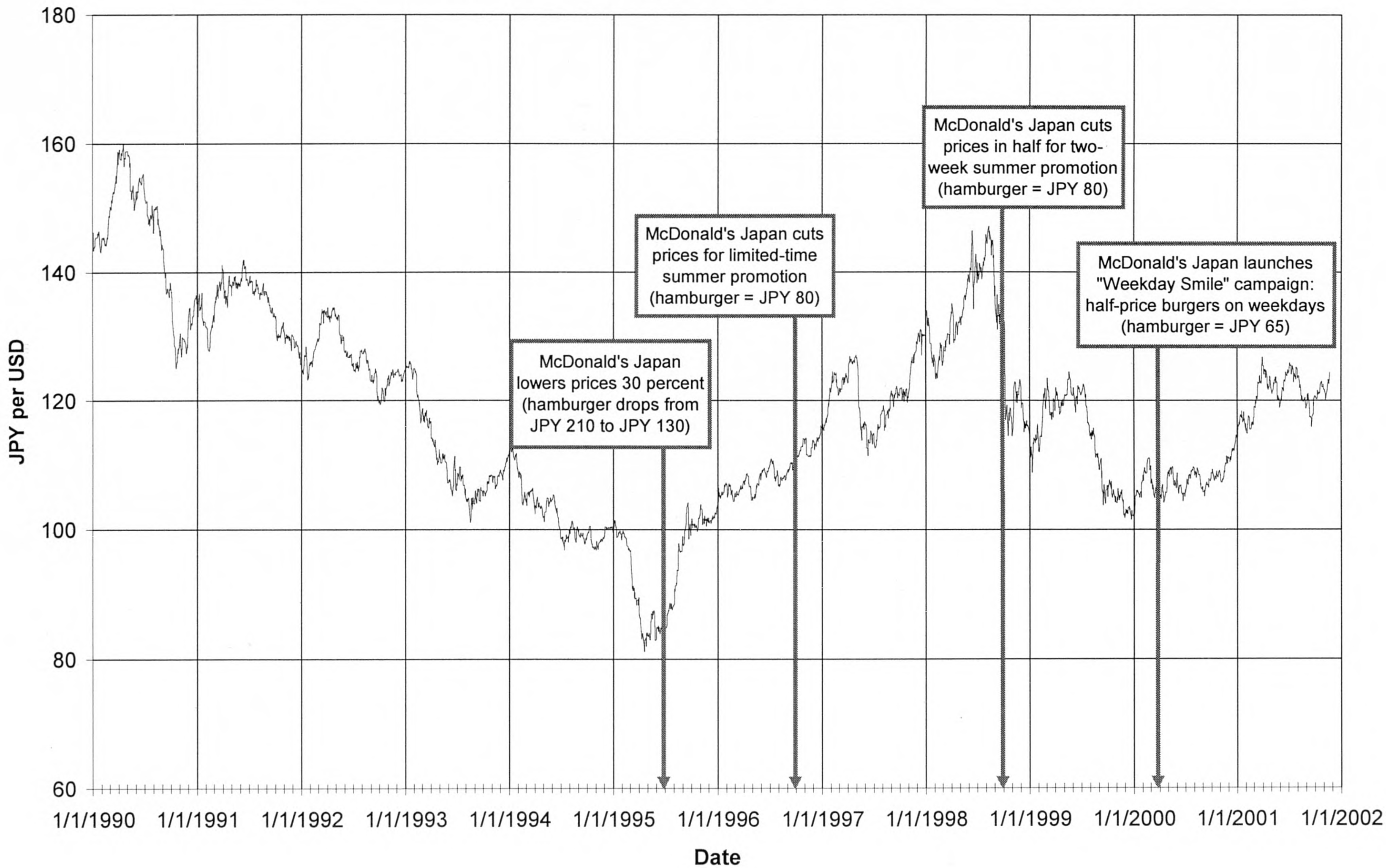
[52] Anonymous, "McDonald's Japan unit to go public", *The Malay Mail*, Malaysia, 1 March 2001, page 27.
[53] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.
[54] Withiam, Glenn, "McDonald's: Hamburger purveyor to the world", *Cornell Hotel and Restaurant Administration Quarterly*, Ithaca, Volume 38, Issue 3, June 1997.

Figure 6
Historical Exchange Rates - Japanese Yen

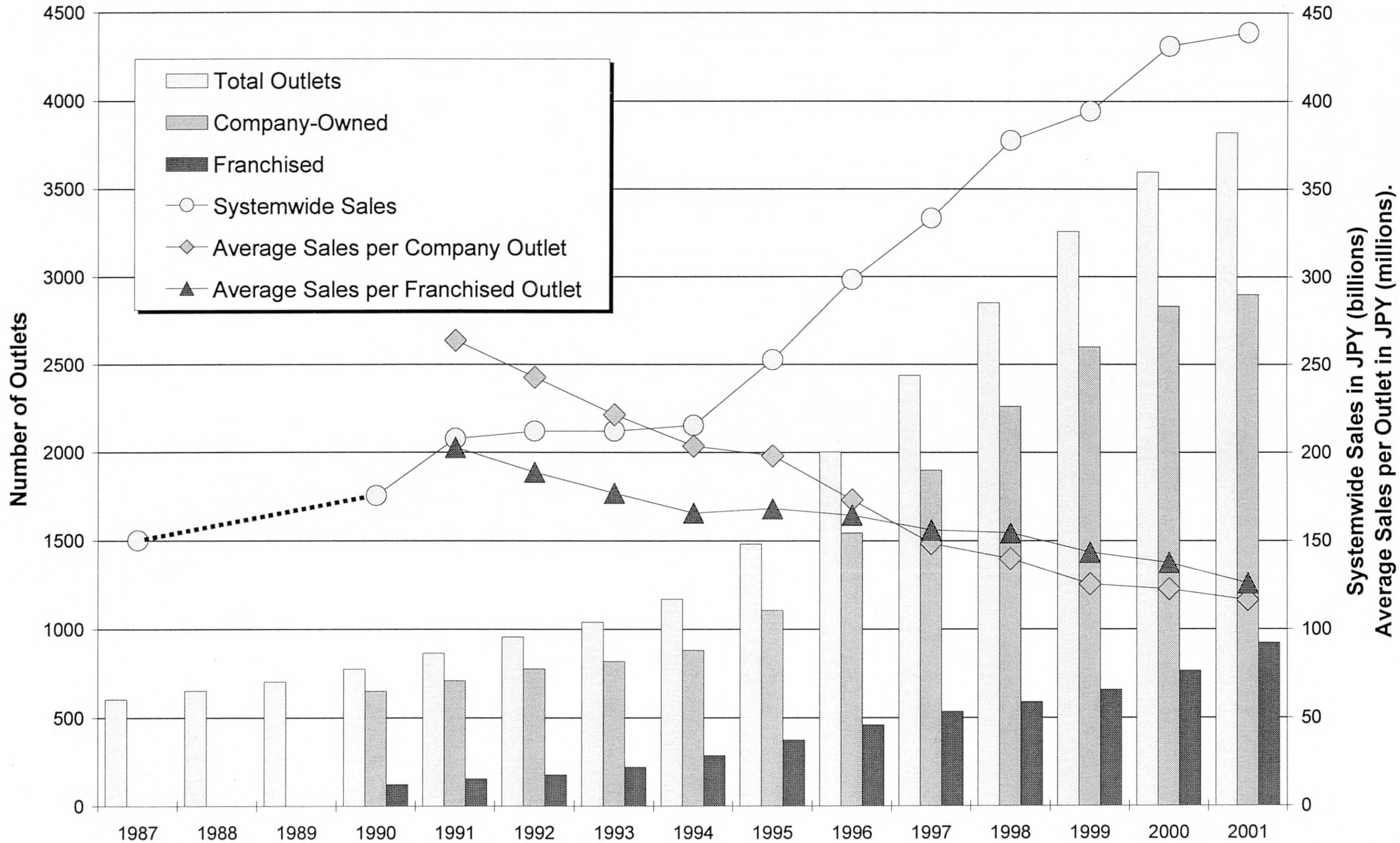


the success of its strategy.[55] Fujita responded to such criticism by noting McDonald's profits in Japan were 11 percent of daily sales – more than double the percentage profit goal set by Ray Kroc 27 years earlier.[56] As data later made public reveals, McDonald's Japan had pre-tax operating profits (recurring profits) that ranged from 8 to 9 percent of its total revenues (which include franchising fees) during the period 1995 to 1998. Although less than the 11 percent profit margin quoted by Fujita, this is strong performance in the fast food industry, and it represented a significant improvement over the early 1990s, when profits ranged from 5.5 to 7 percent of total revenues. And in fairness to Fujita, it may be that the profit margin associated with franchise fees is lower than that for sales at company-owned stores (to which he was probably referring).

Franchising fees actually constitute a relatively small part of McDonald's total revenues in Japan (ranging from 6 to 8 percent). However, the number of franchised outlets is significant. As shown in Figure 7, the percentage of franchised stores in the McDonald's Japan system increased over the last decade, from 16.0 percent in 1990 (the first year for which data are available) to 21.3 percent in 2000. The peak actually came in 1995, when 25.3 percent of all McDonald's outlets in Japan were franchised. It is also noteworthy that McDonald's Japan has not limited franchising opportunities to more remote or isolated markets in Japan (although this was perhaps not always the case). By the end of 2000, franchised stores could be found in all but two of the country's 47 prefectures, and company-owned stores were present in every prefecture.

[55] Most of the historical data presented in this report on McDonald's financial performance in Japan were only made available to the public within the last year, in advance of the company's initial public share offering in July 2001. In limited instances, information was released by company officials, or revealed in the financial reports of McDonald's Corporation, and thus found its way into press reports (such as those cited in this report).
[56] Martin, Richard, "McDonald's Co. Japan Ltd.: A knack for timing and resourcefulness makes McD's successful overseas", Nation's Restaurant News", 26 January 1998.

Figure 7
McDonald's Japan Unit Growth and Sales by Outlet Ownership



Source: McDonald's Co. (Japan) Ltd.

With a relatively large number of individual franchisees, none of which has an exclusive market presence beyond the immediate service area of a local store, and an aggressive corporate growth policy, one might expect conflicts to arise between the parties in the franchise agreement. However, there is no evidence of any problems. McDonald's Japan seems to have reduced the potential for such conflicts in the way it structures its franchising program.

Actually, there are two distinct franchising programs. Internal Franchises, which account for nearly 95 percent of all the franchised stores, are available only to individual employees of McDonald's Japan who meet certain requirements (Operations Consultants with minimum 10 years of service and Grade 7 or higher).[57] This has several advantages for the company, not the least of which are lower costs and reduced risks associated with the selection and training of franchisees. Qualified candidates are well known to the company and already have an intimate understanding of the business (including the company perspective). With 10 years to assess the suitability and loyalty of a potential franchise candidate, there should be few mistakes. The financial structure of Internal Franchise agreements is not known, but based on the magnitude of the franchise fees it collects, typically ranging from 25 to 26 percent of total annual sales by all franchised outlets, McDonald's Japan almost certainly owns the physical facilities (in addition to the land or leases) at most of its franchised outlets. This is McDonald's normal practice in the United States, where franchisees pay a regular rental charge along with a royalty on sales (in addition to the initial franchise or license fee).

In a completely separate program, McDonald's Japan offers External Corporate Franchises to companies that own property which is considered desirable for McDonald's

[57] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.

operations (and is presumably not otherwise available).[58] As one example, an agreement was signed in 1996 with Nippon Oil Company, under which new McDonalds outlets would be opened at about half of Nippon Oil's 10,000 gas stations by 2006. Initially, test stores were to be opened at four or five locations in 1997, to be run by McDonald's. If these proved successful, a full expansion would begin in 1998 with service station workers running the outlets under a franchise arrangement.[59] (The current status of this agreement is not known, but given the modest increase in the number of franchised outlets through the year 2000, it seems the plans may have been scaled back.)

So how do the franchised stores compare with company-owned stores in terms of their financial performance? Unfortunately, publicly available data are not sufficient to answer that question directly. Nevertheless, a few interesting observations can be made. As shown in Figure 7, prior to 1995 average sales per outlet was considerably higher for company-owned stores compared to franchised stores. This difference may simply be a result of the company-owned stores being larger, on average, than franchised stores (and this seems reasonable, based on what is known about how the chain developed). The fact both types of stores experienced a similar decline in average sales per outlet during the economic slowdown from 1991 to 1995 is consistent with such an explanation.

After 1995, however, this pattern reversed, with the franchised stores exhibiting (slightly) higher average sales per outlet compared to the company-owned stores. This suggests that most of the new satellite stores (which have lower sales per outlet) were company-owned. However, since the average sales per outlet continued to decline for both types of stores, at least some of the satellites stores must have been franchised.

[58] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.
[59] Anonymous, "Nippon Oil teams up with McDonald's", *Nikkei Weekly*, Japan, Volume 34, Number 1751, 2 December 1996, page 8.

Otherwise, something else happened that caused lower average sales at franchise outlets specifically, since the average sales at traditional outlets remained fairly constant after 1996 (see Figure 7). Such a possibility seems unlikely, especially considering the best evidence of fair-dealing by McDonald's Japan toward its franchisees: steady increase in the number of franchised outlets over time. If existing franchisees were dissatisfied, or if franchised outlets were consistently under-performing relative to company-owned stores, there would logically be fewer individuals (who are themselves all McDonald's insiders) to fuel an ongoing expansion of the franchising program.

By the end of December 2000, the McDonald's chain had grown to 3598 outlets in Japan (1649 of which were satellites, and 766 of which were franchised). This was an increase of 340 outlets or 10.4 percent over the previous year. Yet the company still did not feel it had saturated the market. Earlier that year, it announced plans to add another 300 to 400 stores annually over the next five years.[60] Once again, business analysts questioned whether McDonald's expansion plans in Japan were overly aggressive.[61] The difference now, however, was they had a legitimate interest in the company's future. McDonald's Company (Japan) Limited was soon to go public.

Transition: Initial Public Offering in Japan

Den Fujita was already 45 years old when the first McDonald's opened in Japan in 1971. As the turn of the century approached, it was only logical to question how long he would continue to run the company, and how a transition to new management might be accomplished. Then in January 1999 came the decision many had long anticipated, as

[60] Steinberg, Brian, "The pitch: Japan's burger wars are getting greasier", *Dow Jones Newswires*, Dow Jones News Service, 8 September 2000.
[61] Racanelli, Vito J., "Recipe for growth", *Barron's*, Volume 80, Issue 50, 11 December 2000, page 19.

McDonald's Company (Japan) Limited disclosed plans for an initial public offering of shares in the company to be held in 2002 through Japan's OTC (over the counter) market. The company also announced that it had signed a 30-year renewal of its franchise license agreement with McDonald's Corporation, thus ensuring the continuation of its rights to operating the chain.[62] (The new agreement also called for an increase in royalty fees from 1.0 percent to 2.5 percent of systemwide sales in Japan effective from January 2001.[63] In a related move, McDonald's Corporation applied to be de-listed from the foreign section of the Tokyo Stock Exchange. The parent company said it had attracted few investors and the costs of being on the exchange outweighed the benefits.[64]

The next news came in June 1999, when McDonald's Japan said it would begin offering shares on the OTC market in the summer of 2001, a year earlier than planned, due to a relaxation of conditions set by the Japan Securities Dealers Association.[65]

As the date of the IPO drew nearer, McDonald's performance came under closer scrutiny by analysts who increasingly questioned the wisdom of aggressive expansion, both in Japan and elsewhere. In December 2000, Amy Crandall, an analyst with Loomis & Sayles was quoted as saying, "Japan has been a disaster," noting that comparable-store sales growth was negative, and suggesting the company was piling too many units into a saturated market. "I have to question if the demand is really there to support this kind of buildup," she said.[66] At least to an outsider, it was not clear how long the company could

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[62] Anonymous, "McDonald's Japan plans IPO, inks 30-year license renewal", *Nation's Restaurant News*, Volume 33, Number 7, 15 February 1999, page 34.
[63] McDonald's Company (Japan) Limited annual results report for 2001, <www.mcdonalds.co.jp>.
[64] Anonymous, "McDonald's pursues delisting from Tokyo Stock Exchange", Asia Pulse, 12 February 1999.
[65] Anonymous, "McDonalds Japan to go public in 2001", *Nikkei Weekly*, Japan, Volume 37, Number 1881, 21 June 1999, page 9.
[66] Racanelli, Vito J., "Recipe for growth", *Barron's*, Volume 80, Issue 50, 11 December 2000, page 19.

sustain aggressive growth without compromising its profitability, especially since it was now competing on lower prices.

A review of historical performance data made public in 2001 does reveal an apparent turnaround in the company's fortunes after 1999. As shown in Figure 8, its revenues and profits had increased steadily from 1994 to 1999, driven by ever increasing sales and unit expansion. System-wide sales growth declined a bit in 1999 (down to just 4.4 percent from 13.3 percent growth in 1998), but pre-tax profits were up by 20.8 percent over the previous year. Then in 2000, despite posting record system-wide sales of JPY 431.1 billion (up 9.3 percent from 1999), McDonald's Japan suffered a decline in profits – its first in seven years. Its 2000 pre-tax profit of JPY 29.3 billion was down 6.72 percent from the previous year.

Den Fujita explained this decline, saying that a reallocation of outlets (presumably from company-owned to franchised stores), and greater spending on new equipment and outlet renovations had eaten into profits.[67] However, since 24 February 2000, the firm had been engaged in a price war, selling its mainstay hamburgers and cheeseburgers at half price on weekdays. This naturally raised concerns about profitability.[68] Perhaps to allay such concerns, Fujita – who just in March 2001 had raised the possibility of further price cuts linked to appreciation of the Yen – declared in mid July 2001 (shortly before McDonald's IPO) that he had no intention of cutting prices further. He added that he was looking to expand, again mentioning his ultimate target of 10,000 outlets nationwide, and predicted that annual sales would reach JPY 1 trillion within ten years.[69]

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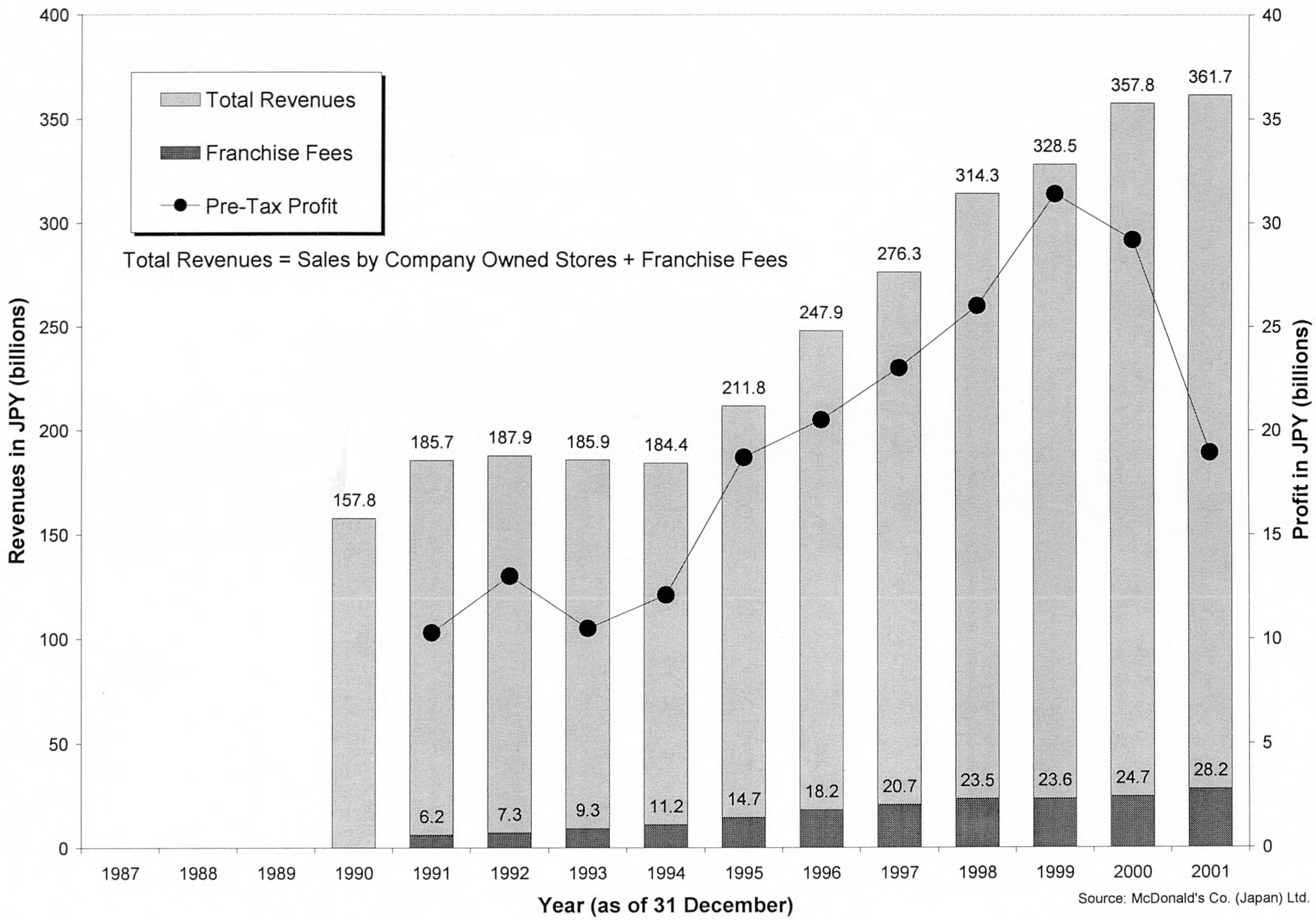
[67] Anonymous, "McDonald's Japan unit to go public", *The Malay Mail*, Malaysia, 1 March 2001, page 27.
[68] Dawson, Chester, "A tall order for McDonald's Japan", *Business Week*, 16 July 2001.
[69] Takenaka, Kiyoshi, "Japan hungry to get a piece of McDonald's", *Reuters News Agency*, 17 July 2001.

Figure 8
McDonald's Japan Corporate Revenues and Profit



Source: McDonald's Co. (Japan) Ltd.

Despite such optimism, McDonald's Japan had actually slowed the pace of its expansion in 2000.[70] Although it added 340 new outlets that year, only 24 of these were traditional outlets (the rest being satellite stores). The number of traditional outlets increased by just 1.2 percent in 2000, as compared to a steady increase averaging 11.3 percent annually during the previous five years.[71] This fact again relates to concerns about profitability. Since traditional stores are more expensive to build, there was obviously a significant reduction in new-store investments in 2000 that should have offset (at least partially) any increased spending on new equipment and outlet renovations, and thus lessened their impact on company profits for that year.

That McDonald's Japan slowed its rate of expansion in 2000 may have been a comfort to some potential investors, but the company seemed disappointed. In January 2001, McDonald's officials explained that cutting back on expansion plans was necessitated by a weakening retail spending climate. They also noted the bankruptcy of department stores in which McDonald's has satellite outlets, along with changes in retail zoning regulations, made it difficult to find high quality locations for new stores.[72] As an example of the more limited opportunities available, McDonald's announced a new alliance with Daiei Corporation, a major, but financially troubled supermarket operator, to open 30 satellite outlets in Daiei stores by the end of 2001.[73]

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[70] Actually, McDonald's rate of expansion in Japan, expressed as a percentage increase in existing outlets over the previous year, had been declining for several years, from a peak of 35.2 percent in 1996 to 14.2 percent in 1999 and just 10.4 percent in 2000. Source: McDonald's Corporation (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.
[71] McDonald's Company (Japan) Ltd, "Investors Guide 2001", downloaded from <www.mcdonalds.co.jp>.
[72] Anonymous, "McDonald's 'unclear' how long impact of BSE crisis will last", *AFX News*, 24 January 2001.
[73] Anonymous, "McDonald's to open shops at Daiei", *Jiji Press English News Service*, Japan, 22 January 2001.

Whatever the reasons, there was no denying McDonald's expansion in Japan slowed even further in 2001. During the first half of the year, the company opened just 82 new outlets, 56 of which were satellite stores. Profits were also down. In July 2001, the Japan Securities Dealers Association said McDonald's Japan expected to post a net profit in 2001 equivalent to USD 123 million, a 12.4 percent decline from 2000.[74] Nevertheless, investors were eager to participate in what was expected to be the largest IPO of the year in Japan.

On 26 July 2001, McDonald's Company (Japan) Limited finally went public, but only in a limited way. The company issued 12 million new shares that were sold at the initial offering price of JPY 4,300. This raised JPY 51.6 billion in cash, part of which was earmarked to fund further expansion.[75] In addition, 14.2 million existing shares were offered to the public by major shareholders (namely, Den Fujita and his two sons). Prior to the IPO, McDonald's Corporation had owned 55 percent of the company, while Den Fujita and members of his family owned about 41 percent (the remaining shares were probably owned by McDonald's Japan employees, but this was not confirmed).[76] After the IPO, McDonald's Corporation (through its subsidiaries) owned a 50 percent stake in the company, while that of Den Fujita and his family was reduced to 26 percent.[77] [78] Thus McDonald's Corporation retained effective control of the local company, while allowing its partner to liquidate a substantial portion of his lifetime investment in the business. It

[74] Dawson, Chester, "A tall order for McDonald's Japan", *Business Week*, 16 July 2001.
[75] Takenaka, Kiyoshi, "Japan hungry to get a piece of McDonald's", *Reuters News Agency*, 17 July 2001.
[76] *Ibid.*
[77] McDonald's Corporation, Financial Press Release: McDonald's Reports Global Results, 24 July 2001, downloaded from <www.mcdonalds.com/corporate/press/financial/2001/07242001/index.html>.
[78] According to McDonald's Company (Japan) Ltd. financial report for the year ending 31 December 2001, Den Fujita's direct ownership of voting rights changed from 16.3 percent in December 2000 to 11.8 percent in December 2001, and those of his eldest son, Gen Fujita, changed from 12.6 percent to 7.5 percent. There was no information provided about any other major Japanese shareholders. However, the report confirmed that Den Fujita's wife, Etsuko, had owned no shares in the company during either year.

also gave ordinary Japanese investors an opportunity to participate, and thus preserved the valuable public perception of McDonald's as a Japanese company built by Den Fujita.

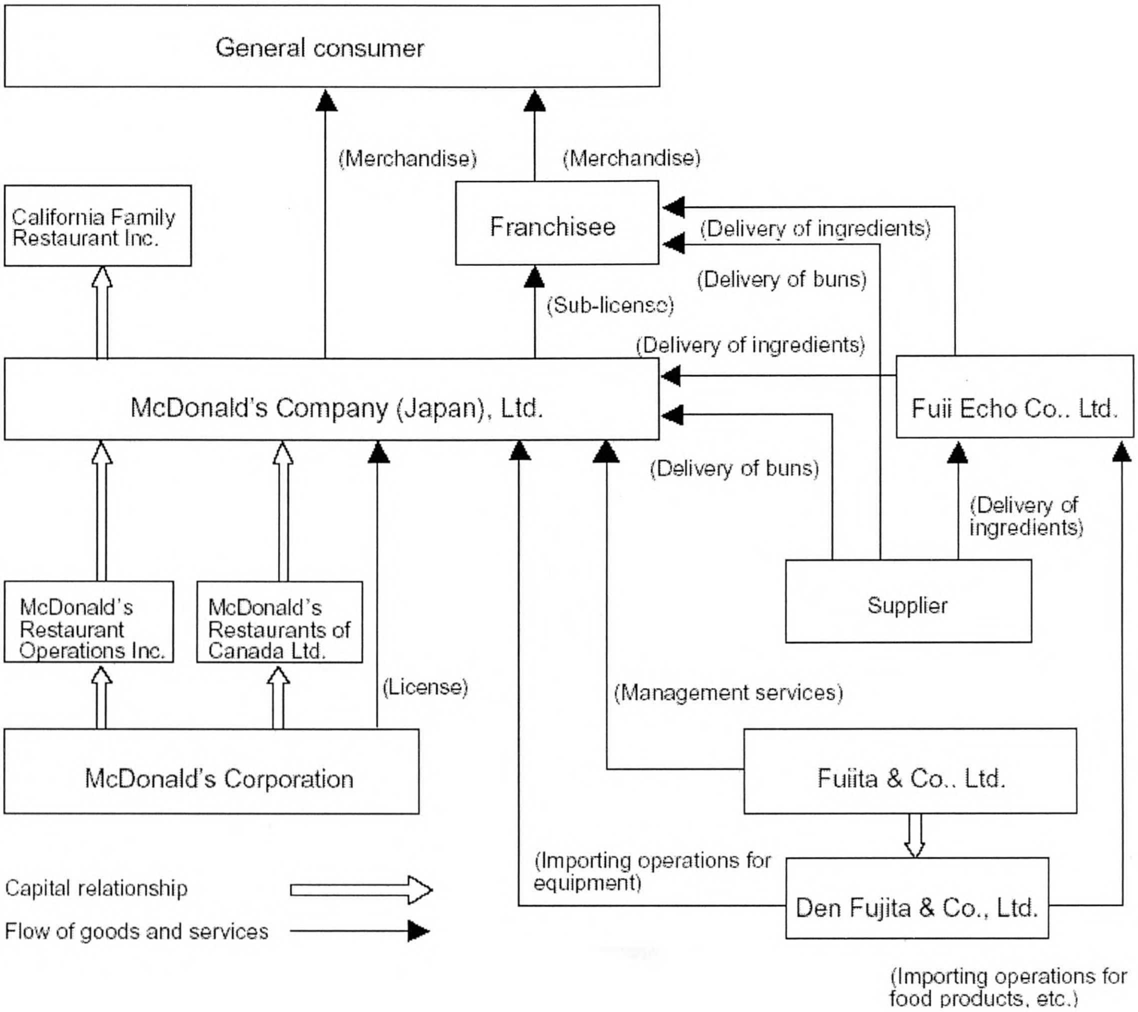
In fact, what Fujita had built was not a single company, but a network of family businesses that provide various services to McDonald's Japan. Details on the ownership structure and relationship of different companies involved with McDonald's Company (Japan) Ltd. were made public as a result of the company's initial public offering, and are summarized in Figure 9. It is apparent from this that Fujita & Company Ltd. still derives a considerable amount of its business from McDonald's. In 2001 Fujita & Company Ltd. received management consulting fees in excess of JPY 2.2 billion (USD 18 million) from McDonald's Company (Japan) Ltd. and imported goods for the company valued at over JPY 25 billion (about USD 205 million).[79] The supply chain situation is also interesting, in that one firm provides logistical and distribution services to McDonald's nationwide:

> Most food ingredients and other materials used by both company-operated and franchised stores, with the exception of buns for hamburgers and other sandwiches, are purchased from Fuji Echo Co., Ltd. (Fuji Echo), a 100% subsidiary of Fujipan Corporation (buns are purchased directly from bakeries). Fuji Echo places orders with suppliers based on demand for ingredients as reported by all McDonald's Japan restaurants (including franchised stores) via a computer network. These suppliers deliver all orders to Fuji Echo's distribution center, and Fuji Echo then delivers the ingredients to individual stores as per their orders.[80]

Unfortunately, little other information could be found (in the English language press) on McDonald's domestic supplier network in Japan.

[79] McDonald's Company (Japan) Limited annual results for fiscal year 2001 <www.mcdonalds.co.jp>.
[80] McDonald's Company (Japan) Limited annual results for fiscal year 2001 <www.mcdonalds.co.jp>.

Figure 9
Capital and Transactional Relationships of
McDonald's Company (Japan) Ltd.



Under a contract with Fujita & Co. Ltd, McDonald's Japan receives a wide range of management information services that are vital in promoting its businesses in the Japanese market. These include:

Consulting Services – Fujita & Co. Ltd. provides consulting services to tailor standard menus and systems received from McDonald's Corporation to make them appropriate for the Japanese market.

Research services – McDonald's Japan receives consulting services on corporate management from Fujita Institute of Future Management Research, a think tank of Fujita & Co. Ltd., to map out midterm management strategies.

In return, Fujita & Co. Ltd. is paid a management fee in the amount of 0.5% of systemwide sales (total sales of company-operated and franchised stores). This fee was reduced from 1.0% of systemwide sales in 2001.

In addition to management services, Den Fujita & Co. Ltd, a 100% subsidiary of Fujita & Co. Ltd., imports food ingredients, equipment and building materials for stores on behalf of McDonald's Japan. Den Fujita & Co. Ltd. charges Fuji Echo Co. Ltd. an import handling fee of 2.5% of the yen settlement amount of the foreign currency price of the imported goods, including shipping.

Sources: McDonald's Company (Japan) Limited Investors Guide 2002 <www.mcdonalds.co.jp/corporation/ir_e.html>
McDonald's Company (Japan) Limited annual results report for 2001 <www.mcdonald's.co.jp>.

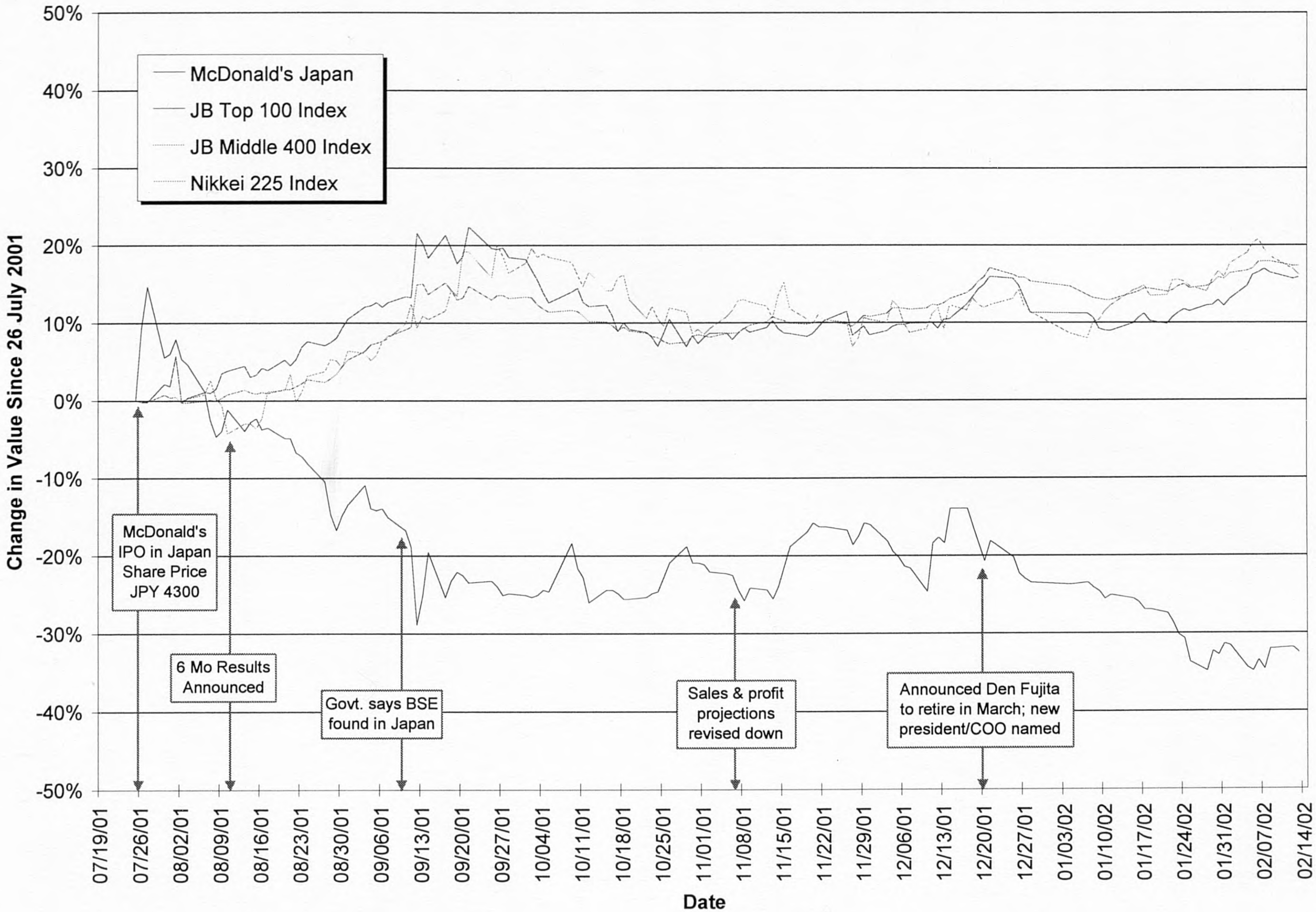
To allay investor concerns about possible changes in senior management after the IPO, McDonald's Corporation announced that Den Fujita would continue to actively manage the business.[81] But this did not address the problem of finding a successor for the 75 year old Fujita. It appeared Fujita had not groomed a successor, and his only public comment was to rule out as possible presidents his two sons, both of whom own stakes in the company.[82] How much longer Fujita might remain as president of McDonald's Japan remained an open question, and no doubt one of great concern to the new shareholders.

On its first day of public trading, McDonald's Japan reached a price of JPY 4,700, on a volume of 2.1 million shares. Its aggregate market value of JPY 624.9 billion was more than Yahoo Japan, and made McDonald's Japan the largest company on the JASDAQ exchange.[83] As shown in Figure 10, this initial exuberance wore off within two weeks as the stock dropped below its IPO price of to about JPY 4100.

Then on 10 August 2001 McDonald's Japan released its first-half results for 2001. Total revenue was up 7.7 percent compared to the first half of 2000, but operating income and pre-tax profit were both down, by 7.8 and 9.6 percent, respectively. The company also projected its total revenue for the year at JPY 378.8 billion (up 5.8 percent from JPY 357.8 in 2000), and its pre-tax profit at JPY 26.96 billion (down 7.7 percent from JPY 29.2 billion in 2000).[84] Although such results should not have been surprising given the ongoing recession in Japan, the news seemed to reinforce shareholder concerns about the stock's price. Within two weeks the stock fell below JPY 4,000, and by early September it was trading around JPY 3,700.

[81] McDonald's Corporation, Financial Press Release: McDonald's Reports Global Results, 24 July 2001, downloaded from <www.mcdonalds.com/corporate/press/financial/2001/07242001/index.html>.
[82] Dawson, Chester, "A tall order for McDonald's Japan", *Business Week*, 16 July 2001.
[83] Anonymous, "McDonald's stock fetches 4,700 Yen on Jasdaq debut", *The Japan Times*, 6 August 2001.
[84] McDonald's Company (Japan) Ltd. Press Release: "Semi-annual result report (non-consolidated) for the first half of the fiscal year 2001, closing at the end of June", 10 August 2001, <www.mcdonald's.co.jp>.

Figure 10
Historical Performance of McDonald's Japan Stock



More bad news came on 10 September 2001, when the Japanese government acknowledged the country's first case of BSE (mad cow disease).[85] Fearful consumers turned away from beef, and McDonald's sales dropped precipitously even though the company widely publicized the fact its beef is imported from Australia and is certified to be free of the disease.[86] McDonald's sales in Japan fell by 17 percent in October, the biggest decline in its history, as the number of customers fell by 14 percent.[87]

Another blow came on 7 November 2001, as McDonald's Japan announced a downward revision in its business projections for the year. Cited as the reason was lower sales than previously anticipated: "Adding to the decline of the general consumer demand due to the prolonged recession, the recent concerns by consumers about beef safety in general has impacted on McDonald's Japan's business to some degree..." The firm's total revenue projection for 2001 was revised down by 5.3 percent, to JPY 358.7 billion (about the same as in 2000), and the new projected pre-tax profit of JPY 20 billion was down 25.7 percent from the projection made just three months earlier (and 31.5 percent below pre-tax profit in 2000).[88]

Despite the latest bad news, McDonald's shareholders seemed comfortable with the stock price, which changed little from mid September and late December (Figure 9). Although it dropped sharply immediately after the government's BSE announcement in early September, the stock price soon stabilized in the range of JPY 3,200 to 3,400. The

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[85] Anonymous, "McDonald's Japan/Revision – 2: Consumer fears over beef", *Dow Jones Newswires*, Tokyo Bureau, 19 November 2001.
[86] McDonald's Company (Japan) Limited Press Release: "McDonald's Japan to launch TV ad campaign to combat BSE impact, stimulate consumption", 15 October 2001, downloaded from <www.mcdonalds.co.jp>.
[87] Heath, Ray, "Japan's Big Mac empire plummets", *Evening Standard*, 19 November 2001.
[88] McDonald's Company (Japan) Limited Press Release: "Announcement of amendment of business projection", 7 November 2001, downloaded from <www.mcdonalds.co.jp>.

profit warning in early November had even less effect, and a week later the stock actually gained value. However, there was yet another disappointment in store for McDonald's optimistic shareholders.

On 20 December 2001 McDonald's Japan announced that Den Fujita would be stepping down as president of the company effective 27 March 2002. However, he will retain the title of CEO and will also assume the newly created position of chairman. The deputy president, Yasuyuki Yagi, was to become the new president and chief operating officer (COO). As explained in a company press release: "McDonald's Japan switched in October 1998 to an executive officer system, under which the board of directors is responsible for policy decisions and supervision, while executive officers are responsible for running the business. By retiring from his post as president, Mr. Fujita will be able to devote his full attention to policy making and supervisory duties as a member of the board of directors. The change will contribute to further growth at McDonald's Japan, for it will improve corporate governance, and will enable management to display greater speed and agility in running the company business"[89]

Despite these and other reassuring words, news of Fujita's upcoming retirement from day to day operations precipitated a decline in McDonald's share price in Japan.[90] By late January 2002 shares in McDonald's Japan were trading at an all time low of JPY 2,800, down nearly 35 percent from the IPO price six months earlier. During this same period the Nikkei 225 and two JASDAQ-Bloomberg (JB Top 100 and JP Mid 400) indexes all gained roughly 15 percent. In some respects, the company may be a victim of

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[89] McDonald's Company (Japan) Limited Press Release: "McDonald's Japan president to assume new position", 20 December 2001, downloaded from <www.mcdonalds.co.jp>.
[90] Anonymous, "McDonald's Japan president to resign, shares down", Reuters, 20 December 2001.

its own success. Having promised and delivered unprecedented growth over its first 30 years, which included long periods of economic recession, McDonald's may now be hard-pressed to satisfy its new shareholders. Only time will tell if the company built by Den Fuijta can continue to be dominant and profitable in the rapidly maturing Japanese fast food market.

HONG KONG

The Partner's Perspective

Not long after its debut in Japan, McDonald's Corporation entered Hong Kong, where it followed a similar organizational strategy. The burger chain selected Daniel Ng Yat Chui as its local partner for business in the colony. Ng was a chemical engineer who had been educated in the United States and United Kingdom. After working seven years as a researcher at the Institute of Gas Technology in Chicago, Ng returned to his native Hong Kong and became a venture capitalist.[1] He originally met McDonald's executives through a local venture capital company, and the parties decided to do business together. They formed a joint venture company, McDonald's Restaurants (Hong Kong) Limited, in which Daniel Ng had a 33 percent share, with McDonald's Corporation owning the rest.[2]

Ng was named managing director of the new venture and was largely responsible for its initial marketing approach, which was considerably different from that followed by McDonald's in Japan. Many people had warned Ng against entering the fast-food business, saying 'Chinese won't eat hamburgers' and 'How can you do market research with food nobody had ever heard of in an ambience no one knows?'[3] Ng credits his boldness to the fact that he did not have an MBA and had never taken any course in business theory.[4] Rather, he relied on his appreciation of local consumer tastes and preferences. Whereas Den Fujita sought to build local acceptance of the McDonald's concept by making it appear more Japanese, Daniel Ng exploited the brand's American origins. As James L. Watson explained in a recent issue of *Foreign Affairs*,

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[1] Love, John F., *McDonald's: Behind the Arches*, Bantam Books, New York, 1995, page 428.
[2] Tanzer, Andrew, "East eats West", *Forbes*, Volume 149, Number 6, 16 March 1992.
[3] Wallace, Charles P., "Fast food in Asia on fast track", *Los Angeles Times*, 9 February 1994.
[4] Watson, James L., "China's Big Mac attack", *Foreign Affairs*, New York, Volume 79, Issue 3, May/June 2000.

> During the early years of his franchise, Ng promoted McDonald's as an outpost of American culture, offering authentic hamburgers to 'with-it' young people eager to forget that they lived in a tiny colony on the rim of Maoist China...Ng made the fateful decision not to compete with Chinese-style fast-food chains that had started a few years earlier (the largest of which, Café de Coral, was established in 1969). The signs outside his first restaurants were in English; Chinese characters for McDonald's (Cantonese: Mak-Bong-lou, Mandarin: Mai-dang-lao) did not appear until the business was safely established. [The homophonic characters together convey no meaning that would make the company appear to be a Chinese enterprise] Over a period of 20 years, McDonald's gradually became a mainstay of Hong Kong's middle-class culture. Today the restaurants are packed wall-to-wall with busy commuters, students, and retirees who treat them as homes away from home. A 1997 survey I conducted among Hong Kong university students revealed that few were even aware of the company's American origins.[5]

The first McDonald's restaurant in Hong Kong opened on 8 January 1975. That same year Kentucky Fried Chicken (now KFC) closed its 11 outlets and withdrew from the colony after a disastrous two-year foray into the new fast food market (KFC did not return to Hong Kong for 10 years). Daniel Ng and his American partners followed a very different approach from that of KFC. "First, McDonald's made massive advertising and marketing efforts that dramatically raised awareness of the fast-food phenomenon among Hong Kong customers, especially among target customers – children and teenagers. Second, new units were added carefully and gradually, and after intense market research. Third, a competitive price strategy positioned the restaurants well in the target market."[6]

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[5] Watson, James L., "China's Big Mac attack", *Foreign Affairs*, New York, Volume 79, Issue 3, May/June 2000.

[6] Lan, Li and Khan, Mahmood A., "Hong Kong's fast-food industry: An overview", *Cornell Hotel and Restaurant Administration Quarterly*, Volume 36, Number 3, Ithaca, June 1995.

From the beginning, Ng advocated a high-traffic, low profit margin strategy. Competing on price meant that new outlets had to be opened with extreme caution to ensure high turnover rates in each store, and expansion occurred slowly in the early years (see Figure 11). Maintaining high turnover was a critical success factor, given Hong Kong's notoriously high property costs and the need to import almost all food supplies. In 1991, sixteen years after McDonald's entered the local market, Hong Kong still boasted five of the world's top-ten grossing McDonald's stores.[7] The next year, seven of the 59 Hong Kong outlets ranked among the top eleven McDonald's stores in the world.[8] By the end of 1993, despite expanding to 75 outlets, the local McDonald's operation still had seven of ten busiest outlets worldwide.[9] More important, McDonald's claimed 20 percent of the fast food market in Hong Kong in 1994 (up from 18 percent in 1993). It was second only to the local Café de Coral (with 25 percent) and well ahead of all other local and foreign competitors.[10] Four years later, after having further expanded to 135 stores, 16 of the top 50 McDonald's outlets worldwide (which then numbered over 20,000) were located in Hong Kong.[11]

The combination of low prices, McDonald's hallmark emphasis on quality, service and cleanliness, and the concept's simplicity (few menu choices, even by McDonald's standards) created a value proposition that appealed to the Hong Kong Chinese. The local company boasts that its Hong Kong customers enjoy the lowest

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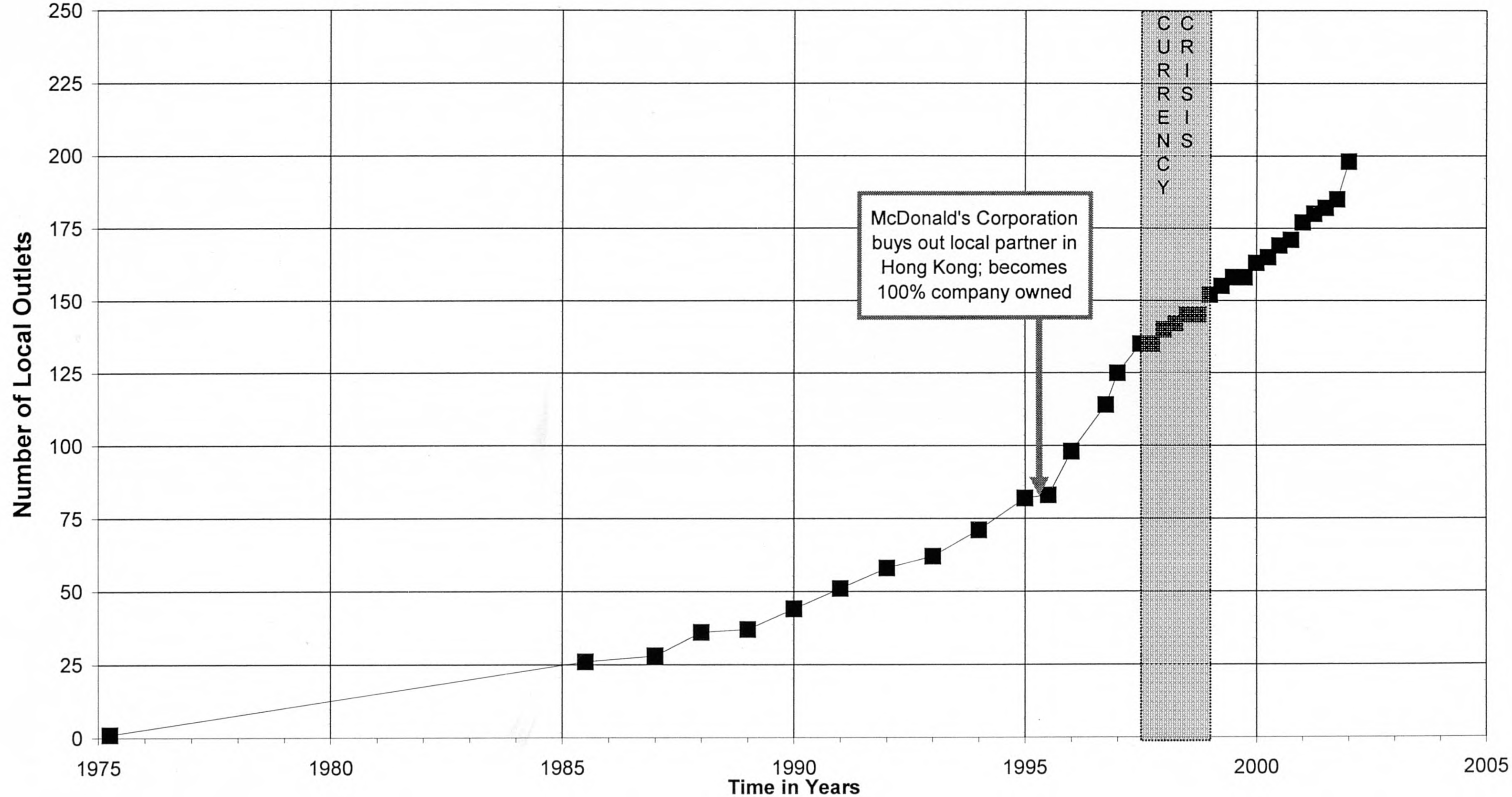
[7] Selwyn, Michael, "The new food dhain", *Asian Business*, Volume 27, Issue 12, Hong Kong, December 1991.
[8] McLaughlin, John, "Hong Kong: New capitalist mecca", *Restaurant Business*, Volume 91, Issue 12, New York, 10 August 1992.
[9] Lan, Li and Khan, Mahmood A., "Hong Kong's fast-food industry: An overview", *Cornell Hotel and Restaurant Administration Quarterly*, Volume 36, Number 3, Ithaca, June 1995.
[10] do Rosario, Louise, "To stay or go?", *Far Eastern Economic Review*, Volume 157, Issue 30, Hong Kong, 28 July 1994.
[11] Anonymous, "Big Mac remains a big deal in Hong Kong", *Chicago Tribune*, Illinois, 28 July 1997, Section 4, page 1.

Figure 11
McDonald's Unit Growth in Hong Kong



McDonald's menu prices in the world. For example, in 1993 a meal consisting of a Big Mac, shake, and medium order of fries cost HKD 21.90. The same meal then cost HKD 29 in the United States and a staggering HKD 63 in Japan.[12] Price was clearly a critical factor in a market where the fast food sector accounted for just 9 percent of total restaurant spending in 1991, compared to 20 percent in Japan and 35 percent in the United States.[13] Other fast food firms found it increasingly difficult to compete with McDonald's low prices, as few could match its high turnover rates.

Transition to Company Ownership

In April 1995, twenty years after McDonald's entered Hong Kong, the company announced that it had exercised its option to buy out Daniel Ng's 33 percent share of their joint-venture, thus becoming sole owner of the business. Financial terms of the deal were not disclosed. McDonald's also announced a reorganization of its Hong Kong operations as part of the company's strategy for greater China, predicting there would be up to 600 outlets in China within the next decade. Don Dempsey, the McDonald's vice president of international marketing, was named as managing director of the reorganized Hong Kong operations, with Daniel Ng being retained as chairman.[14] Ng had been instrumental in helping to open the Chinese market to McDonald's in 1990, and it appeared the company was looking for him to provide additional support in China.

Whether Daniel Ng requested the buyout is not known, but the timing (almost exactly 20 years after McDonald's market entry) suggests it came at the end of the period

[12] Lan, Li and Khan, Mahmood A., "Hong Kong's fast-food industry: An overview", *Cornell Hotel and Restaurant Administration Quarterly*, Volume 36, Number 3, Ithaca, June 1995.
[13] Selwyn, Michael, "The new food chain", *Asian Business*, Volume 27, Issue 12, Hong Kong, December 1991.
[14] Anonymous, "McDonald's buys out its Hong Kong partner", *Wall Street Journal*, Eastern Edition, New York, 13 April 1995.

of the franchise agreement, and Ng's continued participation in the business implies that it was mutually agreeable. It may also be that Ng preferred to cash out his stake rather than seeking an extension to the franchise agreement, under which he would be expected to continue investing in further expansion. The rate of expansion was greatly accelerated after McDonald's Corporation obtained sole ownership in Hong Kong (see Figure 12). In four years, the number of outlets nearly doubled from 83 to 158. Growth slowed only slightly following the onset of the Asian financial crisis that began in 1997. By the end of December 2000, McDonald's had 177 outlets in Hong Kong. One year later, the number had reached 198. The company had achieved and maintained a leadership role in the local Hong Kong's fast food industry. However, such an enviable position brings with it other challenges.

McDonalds in Hong Kong became the subject of protests on 15 October 2000 by both Greenpeace and the Hong Kong Confederation of Trade Unions over separate allegations that the company served genetically modified foods and that a supplier of its promotional toys exploited and illegally employed under-age workers in China. These protests, held on World Food Day, were organized as part of the worldwide 16th annual Anti-McDonald's Day activities.[15]

The charges of labor abuses in China were raised in late August 2000, and McDonald's immediately pledged to investigate the situation.[16] Within two weeks, McDonald's announced that it had found no evidence to support the specific charges of child labor abuses. However, it said that its auditors did discover other problems at the factory in question, and that McDonald's supplier had terminated its contract with the

[15] Anonymous, "Protests against fast-food giant", *Deutsche Presse-Agentur*, 15 October 2000.
[16] Anonymous, "McDonald's HK to investigate child labor allegations", *Dow Jones Newswires*, Dow Jones International News, 28 August 2000.

factory.[17] [18] Labor representatives in Hong Kong then claimed a cover-up.[19] Earlier in the year, in a related event, Lee Cheuk-yan, a legislator and leader of the Hong Kong Confederation of Trade Unions called for McDonald's to implement a minimum wage for its workers in Hong Kong, and warned he would begin a negative campaign against the company if it continued to pay staff 'at such low levels'.[20]

McDonald's Corporation is no stranger to protests in other parts of the world, but prior to this event its Asian operations had been relatively unaffected. That Hong Kong in particular was a target raises some interesting questions: Does the widely known fact that the American parent company is now sole owner of the highly successful local operations help explain these attacks? Does the visible presence of a local individual as McDonald's partner or franchisee help to deter such attacks in other countries? And how did McDonald's handle the public relations aspects of its subsequent equity buyouts in the region?

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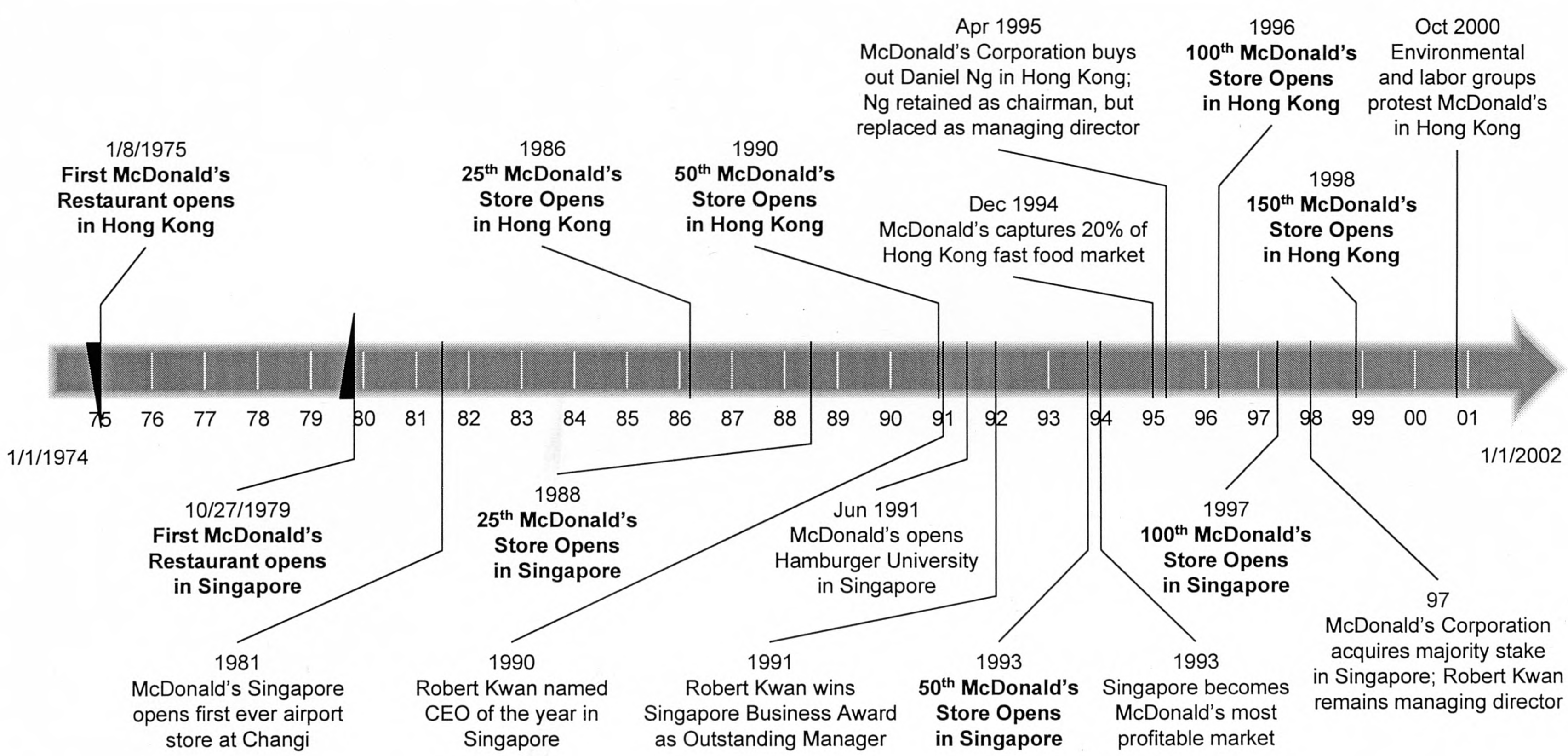
[17] Anonymous, "Labor group: McDonald's toy factory fires underage workers", *Associated Press Newswires*, 4 September 2000.
[18] Anonymous, "McDonald's supplier stops making alleged sweatshop toys in China", *Associated Press Newswires*, 7 September 2000.
[19] Wong, Martin, "Cover-up claim over McDonald's toy factory", *South China Morning Post*, Hong Kong, 9 September 2000, page 4.
[20] Cheung Chi-Fai, "McDonald's in talks rumpus", *South China Morning Post*, Hong Kong, 1 February 2000.

Figure 12
McDonalds in Hong Kong and Singapore Timeline



SINGAPORE

Hong Kong Clone?

Not long after its successful entry into Hong Kong, McDonald's Corporation identified Singapore as its next target market in Asia. Once again, the firm established a joint venture headed by a local entrepreneur to entry the new market. Singapore had many things in common with Hong Kong that made a similar strategy feasible. Its small size, urban population, high per capita income, open trading policy, and almost total reliance on imported food products (not to mention a majority ethnic Chinese population) led the company to seek assistance from Hong Kong in establishing the new venture.

McDonald's Corporation selected Robert Kwan as its local partner in Singapore. Details of any prior relationship between Daniel Ng and Robert Kwan are unknown, but no doubt Ng's confidence in Kwan was a factor in McDonald's decision. At the time Robert Kwan was just 28 years old and not yet a prominent businessman in Singapore. However, his father, Kwan Sai Kheong, was very well known, being a former Director of Education and Vice Chancellor (1975-1980) at the University of Singapore, and serving briefly as Singapore's Ambassador to the Philippines before his death in 1981.[21] Robert chose a different path, leaving school at 18 to enter business. He ran a bookshop at Collyer Quay and was also involved in a wholesale business venture.[22] [23] One source says he ran a small wholesale toy operation before becoming an equity partner with McDonald's.[24] It thus appears the deal with McDonald's was his first really big break.

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[21] "Who Was Who in Singapore", <www.recordSingapore.com>, Dunlop Diverse Pte Ltd.
[22] "Who's Who in Singapore", <www.recordSingapore.com>, Dunlop Diverse Pte Ltd.
[23] Anonymous, "CEO of the Year"
[24] Love, John F., *McDonald's: Behind the Arches*, Bantam Books, New York, 1996, page 428.

In 1978 Robert Kwan and McDonald's established a joint venture company, McDonald's Restaurants (Singapore) Private Limited. The original structure of the joint venture has not been confirmed, but some sources suggest it was a three-way partnership involving Robert Kwan, McDonald's Corporation, and Daniel Ng.[25] It seems more likely that an agreement was actually signed between Robert Kwan and McDonalds Restaurants Hong Kong Limited (in which Daniel Ng then held a one-third share). In any case, McDonald's Corporation (either directly or through Hong Kong) owned not more than 50 percent of the new Singapore operation; even after McDonald's bought out Daniel Ng's stake in the Hong Kong operation in 1995, it still did not have majority ownership of the business. This is known because in 1997 McDonald's Corporation reported a change in ownership of its Singapore affiliate that required the company to consolidate the results from Singapore in its financial reporting. (McDonald's accounting policy is to include in its consolidated financial statements accounts of the Company and its subsidiaries, while investments in affiliates owned 50 percent or less are accounted for by the equity method.[26]) It thus seems likely Robert Kwan originally owned at least a 50 percent share.

The inaugural McDonald's store in Singapore opened at Liat Towers on Orchard Road on 27 October 1979. It soon became the biggest selling McDonald's outlet in the world.[27] A year after this first outlet set the record with over USD 3 million in annual

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[25] One source stated that Daniel Ng owned one-third interest in the McDonald's franchise in Singapore, but this may have been referring to an ownership stake that was held by McDonald's Restaurants Hong Kong Limited. The same source said Daniel Ng was a franchisee who owned 72 outlets in Hong Kong, when in fact he was a one-third joint venture partner in McDonald's Restaurants Hong Kong Limited, which actually owned the stores. Source: Wallace, Charles P., "Fast food in Asia on fast track", *Los Angeles Times*, 9 February 1994.

[26] McDonald's Corporation Annual Reports 1995, 1996, 1997, 1998, 1999, and 2000.

[27] Wallace, Charles P., "Fast food in Asia on fast track", *Los Angeles Times*, 9 February 1994.

sales, another McDonald's in Singapore topped the USD 4 million mark.[28] Seeking other high-traffic locations, the firm opened an outlet at the new Changi Airport in 1981; it was the first ever McDonald's restaurant located within an airport. McDonald's Singapore operations grew at a steady pace during the 1980s, and eventually reached a total of 37 outlets at the end of 1990 (see Figure 14).

Achieving success in Singapore required solutions to several daunting problems. Among these were the country's high occupancy costs and shortage of labor. Singapore has little land area for a relatively large population, and its commercial vacancy rates are low (just four percent in 1996). Monthly rents (also in 1996) generally ranged from US$ 5 to US$ 11 per square foot, with even higher rates in some choice locations. As a consequence, rent as a percentage of sales can reach 20 percent. The situation is complicated by the fact that few leases are offered for longer than a seven-year term because local laws give some rights of ownership to tenants who sign for a longer term.[29]

Singapore also has virtually full employment, which makes it difficult for food service operations to hire and retain suitable staff, especially for line supervision and management positions. To overcome labor shortages, McDonald's pioneered and promoted the hiring of housewives and retirees in Singapore.[30] In addition to these problems, there is almost no local agriculture in Singapore, which makes it necessary for McDonald's to import nearly all its requirements.

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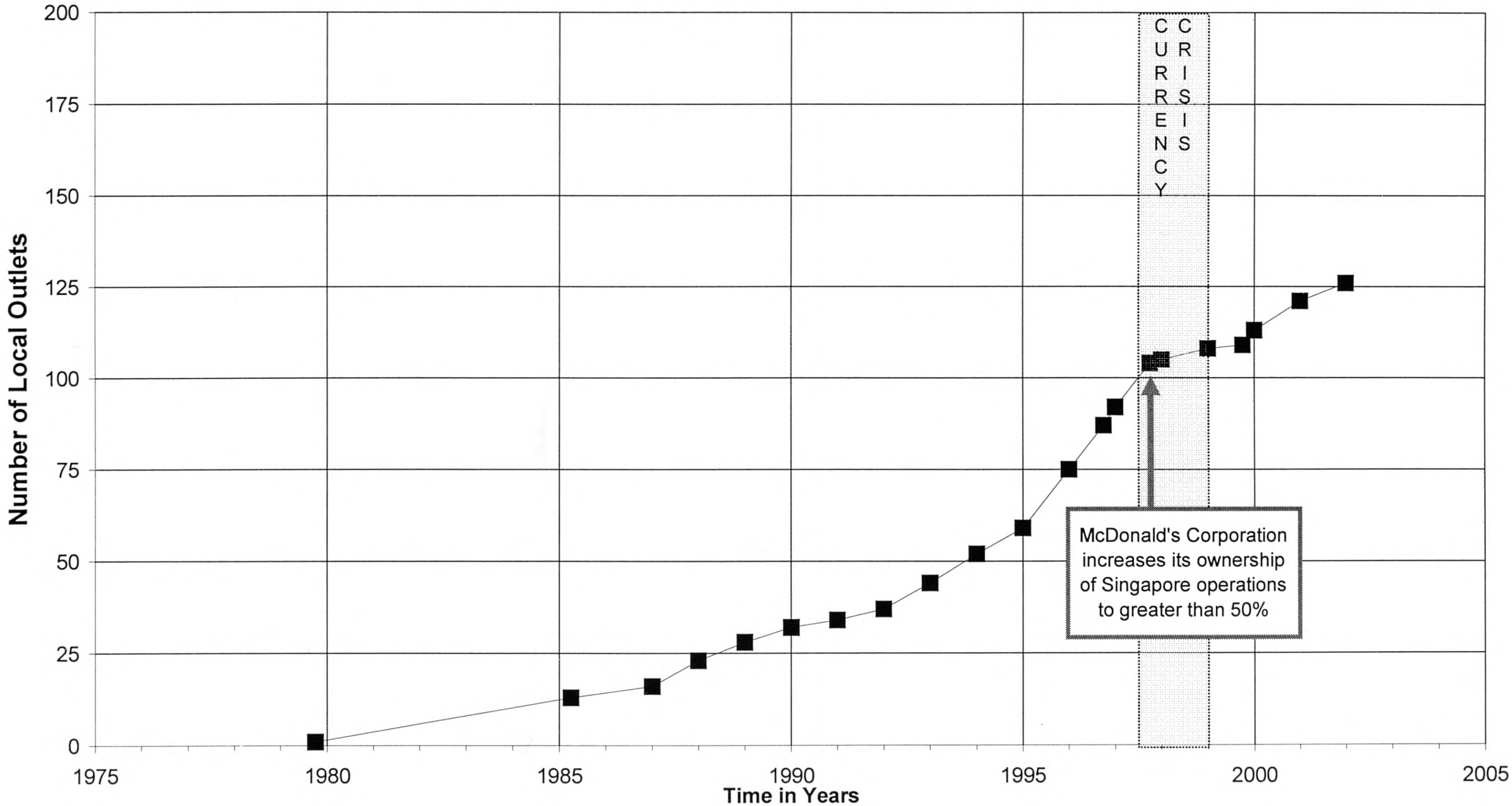
[28] Moskowitz, Milton, "The money tree: The world's largest restaurant business", *The San Francisco Chronicle*, 14 June 1985, page 38.
[29] Kimble, Devin, "Barriers and opportunities in Singapore", *Cornell Hotel and Restaurant Administration Quarterly*, Ithaca, Volume 37, Issue 3, June 1996.
[30] Anonymous, "Singapore Business Awards; Outstanding Chief Executive of 1990", *The Business Times*, Singapore; downloaded from <http://biztimes.asia1.com/bizcentre/sba/oce1.html>

Figure 13
McDonald's Unit Growth in Singapore



In recognition of his success Robert Kwan was named 1990 Outstanding Chief Executive of the Year, an award sponsored by *The Business Times (Singapore)* and DHL Corporation. The accompanying news article lauded his efforts in promoting McDonald's brand, revolutionizing the food service industry in Singapore, and also ensuring that his company was a good corporate citizen, listing a string of community service projects to its name.[31] A year later, Kwan received the Singapore Business Award for Outstanding Manager. The three-time Southeast Asia Games gold medalist in water polo also served as Chairman of the National Council on the Environment and as a member of the Sentosa Development Corporation.[32]

Robert Kwan's personal commitment to the community reflected well on McDonald's, and seemed to confirm that the company's ideals were in line with Singaporean values, perhaps not an insignificant factor in its local success. By 1993 there were 44 outlets in Singapore, and the island republic had become McDonald's most profitable market worldwide.[33] [34] It was also seen as a model operation in other ways. In June 1991 McDonald's Corporation selected Singapore as the location for a regional branch of its Hamburger University to train McDonald's management staff from other Asian countries. Robert Kwan also became personally involved (together with Daniel Ng) as a partner in McDonald's initial entry into China.[35]

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[31] Anonymous, "Singapore Business Awards; Outstanding Chief Executive of 1990", *The Business Times*, Singapore; downloaded from <http://biztimes.asia1.com/bizcentre/sba/oce1.html>
[32] "Who's Who in Singapore", <www.recordSingapore.com>, Dunlop Diverse Pte Ltd.
[33] Rapaport, Richard, "Singapore: still onward and upward?", *Forbes*, 29 March 1993.
[34] Srihanam, Nitsara, "McDonald's suspends expansion plans in Asia", *The Nation*, Bangkok, 27 March 1998.
[35] Anonymous, "Singapore Business Awards; Outstanding Chief Executive of 1990", *The Business Times*, Singapore; downloaded from <http://biztimes.asia1.com/bizcentre/sba/oce1.html>

Meanwhile, McDonald's Singapore continued to expand rapidly during the boom years of the 1990s. The number of its outlets increased 50 percent in just over three years, giving the firm 66 stores by the middle of 1996 – more than any other fast-food chain in Singapore.[36] By the end of that year, the company had added another 26 outlets, for a total of 92 outlets (see Figure 14).

After the Boom

The financial crisis that swept over Southeast Asia late 1997 slowed McDonald's expansion plans in Singapore, but its growth was not stopped altogether. From the end of 1997 to the end of 1999, the number of McDonald's outlets in Singapore had increased modestly, from 105 to 113. This reflected a slowdown in consumer spending, but it was possibly also the result of a change in ownership that took place during 1997.

In its 1997 annual report, McDonald's Corporation reported an increase in its ownership share of the Singapore operation to greater than 50 percent, thus changing its status from an affiliate to a majority owned subsidiary.[37] No other details were provided on current ownership structure (except to confirm that McDonald's now owns something between 50 and 100 percent), and no press reports have been found that refer to any change in the local ownership.

That less than 20 years had passed since McDonald's first opened in Singapore suggests this was not simply a matter of McDonald's exercising its option to buy out the local franchisee (assuming it was a typical 20 year franchise agreement, as appears to

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[36] Kimble, Devin, "Barriers and opportunities in Singapore", *Cornell Hotel and Restaurant Administration Quarterly*, Ithaca, Volume 37, Issue 3, June 1996.
[37] McDonald's Corporation Annual Report 1997.

have been the case of Hong Kong).[38] Perhaps Robert Kwan, like many other business people at that time, had suffered financial losses resulting from the crisis that forced him to liquidate a portion of his stake in the joint venture. Or perhaps he was simply unwilling or unable to make the additional capital investments necessary to continue expanding the chain, which grew to 126 outlets by the end of December 2001. Whatever the reasons, Robert Kwan has remained actively involved in day-to-day operations as managing director of McDonald's Restaurants (Singapore) Private Limited, is still recognized as McDonald's front man in Singapore. Probably few people in the country even suspect that Robert Kwan no longer owns a controlling stake in McDonald's local operations, and there seems little benefit to the company in changing this perception. Nevertheless, one more question is yet to be answered: at what point does McDonald's Corporation buy out his remaining stake?

[38] It seems that most of McDonald's franchise agreements have been for a twenty-year period, as evidenced by the wave of buyouts that first began in the United States after 1975 (twenty years after the company was formed). Internationally, however, there are known have been exceptions to this. The original franchise agreement in Japan was for 30 years (as was an extension signed in 2001), and in Thailand an agreement was signed for 25 years. That the change in ownership took place in Singapore 18 years after the opening of the inaugural store (and 19 years after the establishment of the joint venture company) implies this was an unscheduled event that may have been precipitated by outside forces, such as the financial crisis.

PHILIPPINES

Getting Started

McDonald's representatives first visited the Philippines in 1976, and found the potential market interesting. Shakey's Pizza had introduced its western food concept in the mid-1970s, and many people in the Philippines expressed an interest in becoming McDonald's franchisees. One of these people, George T. Yang, had been talking with McDonald's for five years before he was finally chosen as the firm's local partner in 1979. Although new to the restaurant business, Yang had impressive business credentials that included a marketing degree from DeLaSalle University and MBA from Wharton.[1]

Yang claims middle class beginnings. His grandfather had migrated from China, became an insurance agent, and eventually set up his own insurance brokerage, United Insurance, a firm in which his grandson George later became a shareholder. After finishing college, George Yang worked briefly at a bank before attending Wharton. Later, in addition to his involvement in the insurance business, George marketed cigarettes and operated a jewelry factory with 50 workers in Cubao. His wife later took over that business, and he sold his share in the insurance company, when he started with McDonald's: "I had to give that up because of McDo". In fact, Yang says that he was selected ahead of others in the Philippines because McDonald's liked his dedication to the business.[2]

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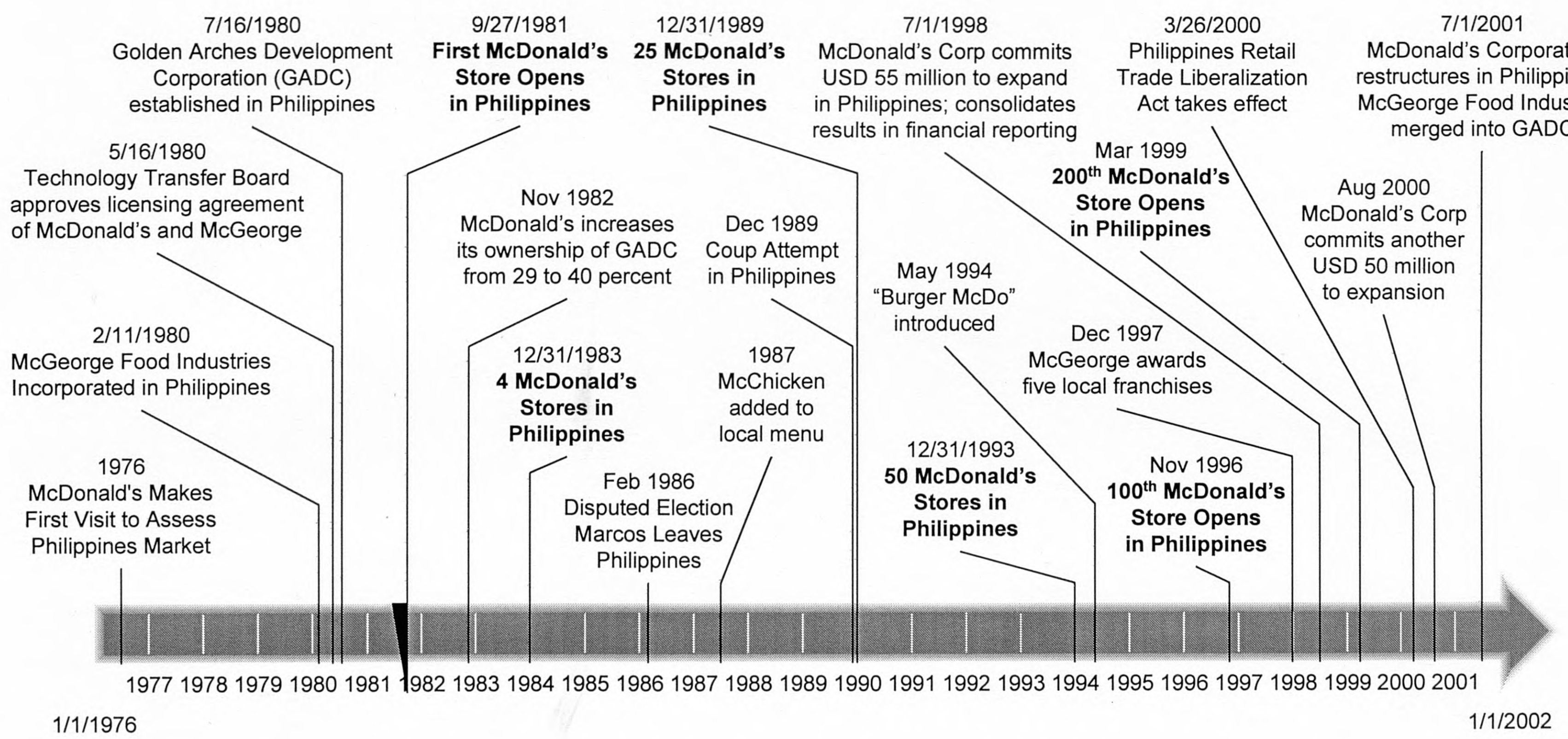
[1] David, Randolf, et al. (consultants to ESCAP/UNCTC Joint Unit on Transnational Corporations), "The Philippines: Case Studies of McDonald's and Coca-Cola", *The Socio-Economic Impact of Transnational Corporations in the Fast Food Industry*, ESCAP/UNCTC Publication Series B, No. 14, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand, 1988, pages 116-124.

[2] Quimpo-Espino, Margie, "Sticking it out with a clean, straightforward food venture", *Philippine Daily Inquirer*, 16 April 2001.

Figure 14
McDonald's in the Philippines Timeline



Aside from its choice of an individual entrepreneur to be its local business partner, the organizational form used by McDonald's to enter the Philippines differed from the successful joint-venture model that it had followed in Japan, Hong Kong and Singapore. This was necessitated by legal restrictions against foreign ownership of retail outlets in the Philippines. As a result, two separate entities were established to manage McDonald's venture in the Philippines.

On 11 February 1980, McGeorge Food Industries, Incorporated was registered with the Philippines Securities Exchange Commission to operate McDonald's retail outlets throughout the country. It was a 100 percent Filipino-owned company with the controlling majority share held by George Yang and members of his family.[3]

A separate entity, Golden Arches Development Corporation (GADC), was established in the Philippines on 16 July 1980 to develop restaurant premises. This is the entity which actually buys and leases real estate, and deals with the banks. McDonalds Corporation initially owned a 29 percent share of GADC and George Yang owned 62.5 percent, with the balance of 8.5 percent held by five other Filipinos, all members of George Yang's immediate family.[4] McDonald's share was initially limited to 30 percent by the Philippines Board of Investment (BOI), but in November 1982 the BOI granted GADC permission to accept additional investments from its American shareholders. As a result, McDonald's equity share was increased to 40 percent.[5]

Under an agreement between these two local companies, GADC took charge of acquiring properties, constructing outlets, and managing non-cancelable leases of restaurant premises to McGeorge Food Industries. The initial lease periods were for 10

[3] David, Randolf, *et al.*, *op.cit.*, pages 116-124.
[4] David, Randolf, *et al.*, *op.cit.*, pages 133-135.
[5] *Ibid.*

years, renewable for up to 10 more years; other rental fees (for equipment, furniture, etc.) were based on percentage of sales.[6]

Another government requirement was responsible for delaying McDonald's entry into the Philippines. McDonald's had initially wanted to import all its requirements, but the BOI insisted that McGeorge Food Industries should utilize local ingredients. This meant the company first had to develop new suppliers from among the local food industries. To develop the hamburger patty it required, McDonald's worked with RFM Corporation, which then had the most modern meat-processing plant in the Philippines and was also a licensee of Swift's Corporation, one of McDonald's major suppliers abroad. For its potato requirements, McDonald's contracted with Halsema Farms in the Mountain Province, and the company's experts taught local farmers the latest farming methods and introduced to the Philippines a virus-free Lemhi Russet strain of potatoes. Goldilucks Bakeshop was signed on to produce hamburger buns and apple pies under a strict agreement that the recipe would be restricted for exclusive use by McDonald's restaurants. Soft drinks were supplied by the local bottling franchise of the Coca-Cola Corporation. Cheese and tartar sauce were supplied locally by Kraft Food Industries, coffee creamer by Carnation, and catsup and pickles by Griffith Laboratories. This left a few food items that still had to be imported, such as onions and ingredients for sundaes, for which there were no local suppliers who could meet the McDonald's standards. Domestic suppliers were also found for some of McDonald's non-food requirements, including packaging materials, uniforms, and some non-specialized kitchen equipment.[7]

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[6] ESCAP/UNCTC Joint Unit on Transnational Corporations, *The Socio-Economic Impact of Transnational Corporations in the Fast Food Industry*, ESCAP/UNCTC Publication Series B, No. 14, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand, 1988, page 19.
[7] ESCAP/UNCTC Joint Unit on Transnational Corporations, *op.cit.*, page 16.

On 16 May 1980 the Technology Transfer Board approved the license agreement between McDonald's Corporation and McGeorge Food Industries. The original license agreement was for five years and stipulated a minimum of five outlets should be opened during this time. It also called for a royalty to be paid to McDonald's Corporation based on a percentage of sales. This royalty fee was less than maximum allowable of 5 percent, and was said to be between 2 and 4 percent (based on financial data it appeared closer to 2 percent).[8] As described, this royalty was exclusive of rental fees charged on individual store premises, at least part of which may have been based on sales. Finally, to assist its local partner in launching the business, McDonald's Corporation reportedly guaranteed George Yang's initial loan of PHP 15 million from Citibank in 1981.[9]

McDonald's opened its first outlet in the Philippines on 27 September 1981, and in December of that same year its second store was opened. The initial rate of expansion was fairly slow. A third store was opened in December 1982, and another was added in 1983. All of these early outlets were located in the Metro Manila area. Concerns about political instability in the Philippines may have contributed to this slow start. Protests over presidential election results in February 1986 had caused Ferdinand Marcos to leave the country, after which Corazon Aquino was named president. A new constitution was enacted early the following year, and it seemed that democracy had been restored.

By the end of 1987, after six years of operation, there were just 13 McDonald's outlets in the Philippines; then the rate of expansion started to increase. The local fast-food market began growing rapidly, as the company added five new stores in 1988 and seven more the following year, for a total of 25 McDonald's outlets by the end of 1989.

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[8] David, Randolf, *et al.*, *op.cit.*, pages 116-124.
[9] Quimpo-Espino, Margie, "Sticking it out with a clean, straightforward food venture", *Philippine Daily Inquirer*, 16 April 2001.

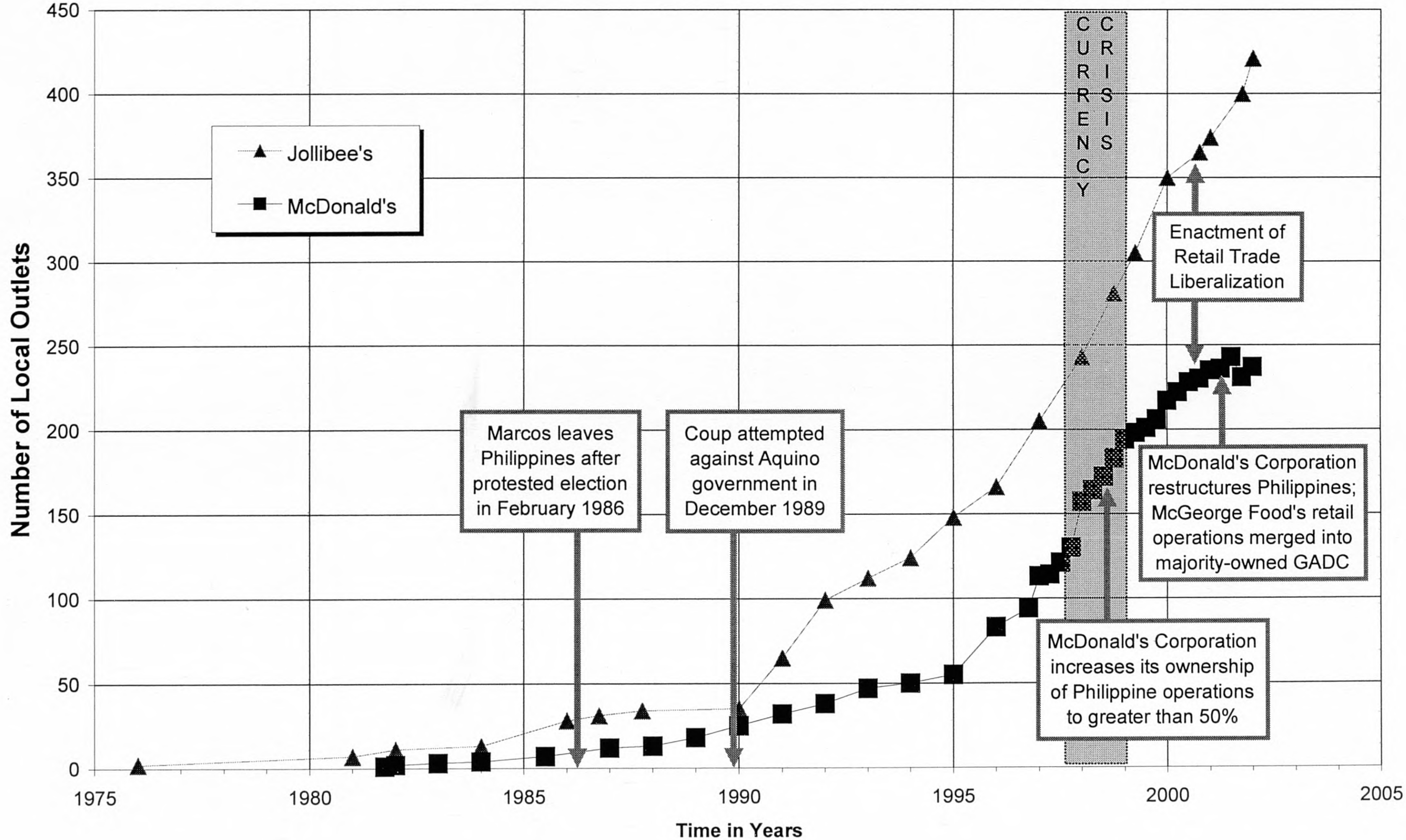
Local Competition and Suppliers

McDonald's principal rival – and the current market leader in the Philippines – is a local chain called Jollibee. The two brands began operations about the same time and competed on a fairly even basis throughout the 1980s as the local fast food market began to grow more rapidly (see Figure 15). However, an attempted military coup in December 1989 caused McDonald's and other foreign-owned businesses to rethink their Philippine investments. As McDonald's slowed the pace of its expansion, Jollibee surged ahead. The local company added 30 outlets in 1990 (compared to just seven for McDonald's) and it soon developed a clear lead in market share.[10] As explained by Raffy Dela Rosa, vice-president of finance for Jollibee Foods, "McDonald's never had the chance to close the gap".[11]

Aside from having fewer store locations, McDonald's faced two other problems in competing with Jollibee. The first was product related. Both conventional wisdom and market research suggested that most Filipinos prefer the sweeter and spicier taste of the Jollibee hamburger to the traditional McDonald's hamburger. Although McDonald's has not abandoned traditional menu items in the Philippines, it did finally introduce its own version of a Filipino-style spicy burger, called Burger McDo, in May 1994. It was an instant success, and offered in combination with other products as McSaver Value Meals, the Burger McDo helped to boost sales by 30 percent.[12] It was one of the few

[10] Filman, Hugh, "Happy Meals for a McDonald's rival", *Business Week*, Industrial/Technology Edition, New York, Issue 3486, 29 July 1996.
[11] Prystay, Cris and Kumar, Sanjay, "Asia bites back", *Asian Business*, Hong Kong, Volume 33, Issue 1, January 1997.
[12] Molina, Exequiel S., "'Filipinized' burger, a McDonald's hit", *Business World*, Philippines, 29 November 1994.

Figure 15
McDonald's & Jollibee's Unit Growth in the Philippines



instances worldwide in which McDonald's has changed the actual burger patty.[13] The chain had previously added to its menu McSpaghetti (1986), fried chicken (1987), banana shakes (1988), barbecue chops and pork teriyaki (1992), a Filipino breakfast called the Longganisa meal (1993), and other items tailored to local tastes (and to counter similar products successfully introduced by Jollibee).[14]

The second problem was price. A central component of Jollibee's strategy was to set its prices on food items 5 to 10 percent lower than McDonald's. McDonald's resisted competing on price in the Philippines, but was determined not to let the price gap widen. At the same time, it was becoming critical for the company to be more cost-conscious and efficient in its operations. According to one source, McGeorge Food Industries generated a profit of just USD 345,000 on sales of USD 77.5 million during 1997. This translates into a profit margin of just 0.4 percent, compared to 6.1 percent profit margin for Jollibee in the same year. Although McDonald's had undertaken a significant expansion during 1997, increasing the number of outlets by 39 percent, the short-term financial impact of long-term capital investments were presumably borne mainly by GADC (for which no results were published) rather than the retail company. The difference in profitability was partly attributed to McDonald's greater reliance on imported ingredients.[15] This problem was further exacerbated as the local currency devalued by some 30 percent in late 1997. As a result of the subsequent financial crisis, inflation rose to 9.7 percent. In response, McDonald's was forced to increase its prices

[13] Filman, Hugh, "Happy Meals for a McDonald's rival", *Business Week*, Industrial/Technology Edition, New York, Issue 3486, 29 July 1996.
[14] Manipon, Roel Hoang, "Scoring a Big Mac", *The Tribune*, Philippines, 20 July 2001.
[15] Espinosa-Robles, Raissa, "Crisis survivor: A Philippine fast-food chain prospers despite the region's economic turmoil", *Asiaweek*, 21 May 1999 <www.asiaweek.com/asiaweek/99/0521/biz1.html>.

by 10 percent, while Jollibee managed an increase of just 8.5 percent.[16] McDonald's clearly needed to improve efficiency and reduce costs in its Philippine operations, a process that had in fact already been underway since the early 1990s.

Cutting costs and developing new products both required that McDonald's work closely with local suppliers to further develop their capabilities, something at which the company excels. Unlike Jollibee, which built its own meat-processing plant, McDonald's continued to purchase beef patties from RFM/Swifts.[17] However, to ensure competitive pricing and quality standards, the company also developed a relationship with GenOSI, a local partnership between General Milling (a Philippine firm) and Otto & Sons, Inc., a long-time meat supplier to McDonald's in the United States. In addition to beef patties, GenOSI also supplies some of newer products McDonald's introduced in the Philippines, including fried chicken (with chicken parts sourced locally from Magnolia, PureFoods and Home Pride), fish fillets (made from frozen fish blocks imported from Australia), spaghetti sauce, pork sausage, and Chicken McNuggets.[18] Another local company, Blue Dairy (a family-owned company headed by Ed Aviguitero), was established in 1992 to supply McDonald's with strawberry milk, orange drinks, shakes and soft serve ice cream. It also supplies fresh vegetables to McDonald's.[19]

Another key to improving local efficiency was logistics. McDonald's found the answer by convincing another of its worldwide suppliers to establish local operations in the Philippines. HAVI Food Services Philippines, Inc. is a local affiliate of the Chicago-based HAVI Group LP, a company that provides food distribution and warehousing

[16] Espinosa-Robles, Raissa, "Crisis survivor", *Asiaweek*, 21 May 1999.
[17] Alday, Cleo A., "Meat processing equipment: Phillippines", Industry Sector Analysis, U.S. & Foreign Commercial Service, 1 March 1998, <http://www.tradeport.org/ts/countries/philippines/isa/isar0015.html>.
[18] Tan-Co, Felicidad V., "Production the McDonald's way", *Business World*, Philippines, 31 March 1994.
[19] *Ibid.*

services, logistics and supply line management, packaging, wholesale baking, premium and promotional activities, and leasing of temperature-controlled delivery equipment to McDonald's Corporation and other strategically aligned companies in the United States and Asia.[20] Organized in June 1991 under the name of Prodigy Distributors, Inc. (changed in 1994), HAVI Philippines is a 60 percent Filipino-owned company. Within three years, HAVI was serving all 55 of McDonald's outlets in the Philippines and had capacity to supply a total of 120 outlets.[21] The HAVI Group has other local affiliates that operate warehousing and distribution services for McDonald's in Hong Kong, Singapore, Philippines, Thailand, Taiwan and China, and wholesale bakeries to supply McDonald's in Malaysia, Taiwan, and Singapore. HAVI's success in the region is thus directly linked to that of McDonald's.

Despite these changes, McDonald's continued to lag behind its main competitor in the Philippines throughout the 1990s. By 1992 Jollibee had established itself as the Philippines fast-food market leader. Its sales that year were PHP 2.3 billion, compared to just PHP 890.7 million for second-place McDonald's. (Golden Donuts, a local name for the Dunkin' Donuts chain, was in third place with sales of PHP 363 million.)[22] In 1993 Jollibee reportedly captured 57 percent of all fast food revenues in the Philippines.[23] By 1995, McDonald's sales had grown to PHP 1.6 billion, and the company was projecting sales of PHP 3 billion for 1996.[24] However, despite impressive growth, a survey in early

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[20] Anonymous, "The secrets behind McDonald's and its hamburgers", *Business World*, Philippines, 15 September 2000, page 31.
[21] Tan-Co, Felicidad V., "Production the McDonald's way", *Business World*, Philippines, 31 March 1994.
[22] Bunoan, Vladimir S., "Fastfood has the biggest growth potential", *Business World*, Philippines, 21 April 1994.
[23] Anonymous, "Jollibee eyeing setup of at least 500 branches by turn of the century", *Business World*, Philippines, 27 June 1994.
[24] Molina, Exequiel S., "McDonald's projects P3 B in sales for 1996", *Business World*, Philippines, 12 November 1996.

1996 showed Jollibee's 177 outlets still commanded a 46 percent market share (based on number of visits), compared to just 16 percent share for McDonald's 90-outlet chain.[25] A year later, in April 1997, a survey by the Philippines Stock Exchange again gave Jollibee a 46 percent market share (it was probably also based on number of visits) compared to 15 percent for McDonald's and 8 percent for Wendy's.[26] Yet another survey reported in early 1997 said that Jollibee was responsible for 27 percent of all Philippine restaurant industry revenues, compared with 9 percent for McDonald's and 5 percent for Wendy's.[27] Although Jollibee's market share based on sales had been reduced from 1993 to 1997, there was not a corresponding increase in McDonald's market share.

Franchising and Business Alliances

Although menu, pricing and profitability were all important factors, it seemed the only way for McDonald's to compete with the ubiquitous Jollibee was through continued expansion of its retail operations. In January of 1997, George Yang announced ambitious plans to add another 100 stores (for a total of 200 outlets) within just 18 months. At the time, Jollibee already had 200 outlets in operation, along with aggressive expansion plans of its own.[28]

As one way to facilitate rapid expansion, McDonald's considered sub-franchising new outlets. Prior to 1997, the only reference found on sub-franchising in the Philippines was a brief 1995 article that mentioned in passing a McDonald's franchise in St. Francis

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[25] Filman, Hugh, "Happy Meals for a McDonald's rival", *Business Week*, Industrial/Technology Edition, New York, Issue 3486, 29 July 1996.
[26] Ortiz, D'Laarni A., "Optimism at Jollibee Foods Corp.", *Business World*, Philippines, 24 February 1998.
[27] Anonymous, "Philippines is hamburger heaven for Jollibee", *Nikkei Weekly*, Japan, Volume 35, Number 1775, 26 May 1997, page 22.
[28] Prystay, Cris and Kumar, Sanjay, "Asia bites back", *Asian Business*, Hong Kong, Volume 33, Issue 1, January 1997.

Square owned by Lily Monteverde, a local movie producer.[29] It therefore appears that sub-franchising was only a minor factor in the first 15 years of McDonald's growth in the Philippines. Neither was there much evidence of previous corporate alliances with other local retailers. Then in January 1997, it was reported that McGeorge Food Industries was discussing plans for a joint venture with Caltex (Philippines) Inc. to set up McDonald's outlets at the oil company's service stations.[30] [31] About this same time the company also began actively seeking individual franchisees.

In December 1997 McDonald's announced it had selected five new franchisees in the Phillippines, each of which "is granted a franchise to own and operate a McDonald's restaurant in a specific site after going through a training and evaluation program." The article referred to "McDonald's aggressive licensing and franchising program", but gave no names or other information about the new (or any existing) franchisees except to note that they come "from various parts of the country."[32] An article in April 1998 said, "Mr. Yang also disclosed that McDonald's commitment to the country is visible not only in the company's store expansion plans but also in providing viable business opportunities to entrepreneurs by way of franchising."[33] Once again, however, the article gave no specific details on either individual franchisees or the locations of their stores, which seems a bit curious if the company were serious about promoting franchising as part of its expansion strategy.

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[29] Jao-Grey, Margaret, "Bank notes morality code in bank heists", *Business World*, Philippines, 7 June 1995.

[30] Serapio, Manolo A., Jr, and Francisco, Rosemarie V., "Caltex-McDonald's tie-up to fuel more competition", *Business World*, Philippines, 21 January 1997.

[31] *Ibid.*

[32] Molina, Exequiel S., "McDonald's awards five new franchises", *Business World*, Philippines, 9 December 1997.

[33] Anonymous, "McDonald's to pursue expansion program", *Business World*, Philippines, 2 April 1998.

The absence of other articles on McDonald's sub-franchising program in the late 1990s suggests it has remained of limited scope and scale. Perhaps the Asian financial crisis that began in late 1997 together with the continued success of Jollibee (which made extensive use of franchising to expand its chain) hampered McDonald's efforts to identify suitable franchise candidates. Not only must such individuals possess adequate financial resources, McDonald's also requires them to commit themselves full-time to personally managing the franchise. Considering 124 of the Jollibee's 205 outlets in the Philippines in December 1996 were operated by franchisees (this excludes the outlets of Jollibee's other fast food subsidiaries), it simply may be the pool of qualified candidates available to McDonald's was rather small even before it was further reduced by the financial crisis. Similarly, opportunities for business alliances may have been reduced as a result of the crisis. For example, no confirmation has been found that McDonald's and Caltex ever finalized (much less implemented) their proposed joint venture agreement.

Despite the apparent lack of activity in recent years, McDonald's appears to still be interested in opening additional sub-franchised stores in the Philippines. An article in June 2001 said the company was planning to open 25 to 30 new stores in 2001, mostly in the provinces through franchising.[34] However, it again gave no other details on the firm's franchising program or individual franchisees.

Crisis and Opportunity

The financial crisis that hit Southeast Asia beginning in late 1997 did little to alter McDonald's expansion plans in the Philippines. Despite the limited role of franchising, McDonald's still managed significant unit growth in 1997 and finished the year with 157

[34] Anonymous, "McDonald's to continue 2-yr expansion program", *Business World*, Philippines, 22 June 2001.

outlets, a 39 percent increase over the previous year. Meanwhile, Jollibee expanded its own chain by just 19 percent, to a total of 243 local stores in the Philippines (again, not counting its other fast food subsidiaries).[35] The next year McDonald's in the Philippines grew by nearly 24 percent, to 194 outlets, and by March 1999 it had passed its goal of 200 outlets – just nine months behind the original schedule. In the same period Jollibee expanded its chain to 305 outlets. It looked like McDonald's was finally starting to close the gap between them (see Figure 15).

Perhaps McDonald's Corporation saw an opportunity in the financial crisis, and made a significant commitment to exploit it. The gains it made against Jollibee in 1997 and 1998 may have been facilitated in part by a financial weakness of its rival. Not only had Jollibee expanded rapidly in the Philippines during the 1990s, it also spent money branching out to a dozen overseas markets and acquiring other local fast food subsidiaries (Greenwich Foods in 1994, a 50:50 joint venture to operate the DeliFrance chain in 1995, Magic Donut in 1996, and Chow King in 1999). Partly to finance these investments, Jollibee had borrowed USD 28.9 million in foreign currency in 1996. A year later, when the local currency plunged 30 percent against the dollar, Jollibee's interest payments soared, which caused its profit to fall by 27 percent in 1997. Jollibee desperately needed an infusion of cash that could only come from outside the country. With the Philippine law banning foreign ownership of retail companies, Jollibee responded in February 1998 with the innovative solution of issuing tradable warrants backed by common stock that it held in trust. The revenue from these warrants, 85 percent of which were sold to foreigners, allowed the company to pay off all of its foreign debt and still leave it with

[35] Ortiz, D'Laarni A., "Optimism at Jollibee Foods Corp.", *Business World*, Philippines, 24 February 1998.

USD 21 million in cash.[36] Nevertheless, a small window of opportunity had been opened and McDonald's seemed determined to take advantage of it.

Despite having grown at a compounded rate of over 25 percent for seven years, officials of McDonald's Corporation remained dissatisfied with their competitive position in the Philippines. Early in 1999 George T. Yang revealed that his American partner had recently committed to provide USD 55 to McGeorge Food Industries for use in financing expansion projects for two years. At he explained, the McDonald's commitment would allow the retail operations in the Philippines to remain in private hands while continuing its growth strategy. The advance (as it was called in the article) will be enough to finance all expansion activities until 2000.[37] Of course, given the structure of McDonald's local operations it is likely that most of this money was actually committed to GADC, rather than to the retail company, McGeorge. And what received no mention in the local press at the time is that George Yang's ownership in the local McDonald's operations had been effectively reduced to less than 50 percent.

As in Singapore a year before, McDonald's Corporation reported that during 1998 it acquired a majority ownership stake in its Philippine business.[38] Exactly what this majority stake entailed is not known. The retail operations of McGeorge Food Industries necessarily would have remained under the control of George T. Yang (and his Filipino partners), since foreign interests were still not allowed to own any stake in local retail

[36] Espinosa-Robles, Raissa, "Crisis survivor", *Asiaweek*, 21 May 1999.
[37] Anonymous, "McDonald's commits $55M to Philippine franchisee", *Businessworld*, Philippines, 18 March 1999.
[38] This conclusion is based on the following excerpt from McDonald's Corporation 1998 Annual Report: "Capital expenditures by affiliates, which are not included in consolidated amounts, were approximately $295 million in 1998, compared with $360 million in 1997. The decrease was primarily due to increased ownership in the Philippines, South Korea and Thailand, which converted them from affiliates to majority-owned subsidiaries in 1998, and to a lesser extent, weaker foreign currencies".

companies under Philippine law.[39] However, McGeorge Food Industries was not the capital-intensive side of the business – that part was GADC. It thus appears McDonald's Corporation had made unilateral capital investments in GADC that were sufficient to require its consolidation of results from the Philippines in financial reporting starting in July 1998.[40] As with Singapore, McDonald's did not report its effective ownership share in the Philippines, but by definition it was over 50 percent and less than 100 percent.

This conclusion is disputed in later reports claiming that McDonald's owned only 40 percent of GADC in November 2001.[41] A few months before then, George T. Yang insisted he still owned 50 percent of GADC.[42] Assuming these reports were accurate, it may be that McDonald's latest investments in the local operations had come in the form of loans, and thus did not affect legal ownership of GADC or McGeorge Food Industries. However, loans to an affiliate might still require McDonald's to recognize its total risk in the Philippines, which it could do by consolidating the local results as if from a majority owned subsidiary. This may have been done to circumvent the government restrictions on foreign ownership or (as his own explanation seems to suggest) to provide temporary assistance to George T. Yang as he pursued aggressive expansion plans.

It is possible that Yang had suffered financial setbacks as a result of the financial crisis and was (at least temporarily) unable to match planned investments by McDonald's

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[39] In addition to George T. Yang, the majority shareholder, Paranaque Representative Roilo Golex, academician Bernardo Villegas, Cristina Yang, Jesusa Osorio Yang, Yang Ing Kuong, Shirley Yap, and Ramon Quisumbing, Jr. were also identified as shareholders of McGeorge Food Industries, Inc. in early September 1996. (Several if not all of these are believed to be members of George T. Yang's immediate family.) Source: Anonymous, "Golez, Villegas Included in McDonald's Case", *Business World*, Philippines, 6-7 September 1996.

[40] McDonald's Corporation Financial Press Release: "McDonald's reports global results", 20 July 1998, <http://media.mcdonalds.com/secured/news/pressreleases/1998/Press_Release07201998.html>.

[41] Cabacungan, Gil C., Jr., "McDonald's to firm up control of RP operations", *Philippines Daily Inquirer*, 18 November 2001.

[42] Quimpo-Espino, Margie, "Sticking it out with a clean, straightforward food venture", *Philippine Daily Inquirer*, 16 April 2001.

Corporation. Or perhaps he was simply ready to accept a reduced equity stake in advance of his actual retirement. In either case, the extension of convertible loans by McDonald's might make sense, especially since a relaxation of the foreign ownership restrictions on retail operations was expected in the near future. Further, there is evidence that George Yang had already reduced his involvement in the McDonald's business. About the same time that McDonald's made its commitment of USD 55 million and reported its change in ownership (1998), an American executive was named as the new managing director with responsibility for day to day operations in the Philippines. According to Yang, this was done to allow him more time to concentrate on policy and strategy tasks related to the McDonald's business. For example, Yang said that he still has the final say on new sites for McDonald's restaurants, noting they had made costly mistakes before (and implying it was because he was involved too involved with other matters).[43] However, the change in management structure also allowed Yang to participate more actively in other business ventures.

Over the years George T. Yang had become involved as an investor in several businesses other than McDonald's. By early 1996 (and perhaps long before then) he was a director and major shareholder in the Bank of Southeast Asia (BSA). Founded as a thrift bank in January 1983, BSA received approval for conversion into a commercial bank in December 1995. At the time it had eight branches, mostly in Metro Manila, with plans to open 10 more branches within a year.[44] George Yang was identified as one of three major shareholders in the bank when discussions were underway in September 1997

[43] Quimpo-Espino, Margie, "Sticking it out with a clean, straightforward food venture", *Philippine Daily Inquirer*, 16 April 2001.
[44] Garcia, Elisha R., "Bank of Southeast Asia is latest to get KB license", *Business World*, Philippines, 19 March 1996.

for Development Bank of Singapore (DBS) to acquire a 40 percent share in BSA.[45] His name appeared on a longer list of major shareholders when DBS signed an agreement to purchase 60 percent of BSA and its subsidiaries in January 1998.[46] Aside from banking, Yang led a group of at least five other local businessmen who in January 1997 signed a memorandum of understanding with Cosmo Oil Company (Thailand) Limited to explore the potential for setting up gasoline stations and storage facilities in the Philippines (at the same time he was negotiating a possible joint venture between McDonald's and Caltex).[47] Also in January 1997, George Yang's name appeared as a minority owner of Summit Point Corporation, a consortium of five local investors and a foreign firm which planned to build a golf course and other facilities in Batangas.[48]

More significantly, Yang owned a controlling stake in Yorkshire Holdings, Inc., which in early 1998 had acquired 67 percent of Anglo-Watson Philippines, Inc., a glass container manufacturer that supplies liquor and beverage makers. The Anglo-Watson name was changed to Alliance Global, Inc. in August 1998, and the firm has since been transformed into a holding company with several food and beverage businesses.[49] In January 2001, George T. Yang (through his Yorkshire Holdings) was reported to control 83 percent of Alliance Global as the firm announced it would be receiving new equity investments from California Orchard Growers' Investments, Inc. and American Growers Corporation. Allied Global was also planning to list shares on the Singapore Stock

[45] Samonte, Sheila A., "Singapore's biggest bank buys into Bank of SE Asia", *Business World*, Philippines, 8 September 1997.
[46] Garcia, Elisha R., "Singapore's banking giant buys majority of local bank for P1.7B", *Business World*, Philippines, 15 January 1998.
[47] Serapio, Manolo A., Jr., "Cosmo Oil, local group to build gas stations, oil storage depots", *Business World*, Philippines, 22 January 1997.
[48] Serapio, Manolo A., Jr., "Summit Point to build P3.5-B golf course in Batangas", *Business World*, Philippines, 24 January 1997.
[49] Dumlao, Doris C., "US firms acquire 14% stake in Alliance Global for P 3.22 B", *Philippine Daily Inquirer*, Philippines, 16 January 2001, page 2.

Exchange.[50] In addition to being chairman of Alliance Global, George Yang reportedly holds chairmanships and directorships in 25 other companies.[51]

Meanwhile, McDonald's chain in the Philippines continued to expand, and in August 2000 McDonald's Corporation announced another major investment of USD 50 million to grow its then 220-outlet Philippines operation over next three years. This was about PHP 750 million a year compared to the PHP 1 billion reportedly being spent by Jollibee. McDonald's was still committed to catching up with (or at least not fall further behind) the market leader, which had previously announced plans to open 50 new outlets (for a total of 450) before the end of 2001.[52]

Jollibee later scaled back its expansion plans after posting flat income growth in the third quarter of 2000, which the company blamed on weak demand brought on by a decline in the value of the peso and rising petroleum costs.[53] Perhaps the local company was also suffering another cash crunch after its many years of aggressive expansion (both domestically and overseas), several major acquisitions, and declining share prices. By September 2000, Jollibee Foods Corporation reported a total of 365 Jollibee outlets, 189 Greenwich Pizza, 155 ChowKing, and 9 DeliFrance restaurants in the Philippines. It also had another 29 Jollibee stores in 13 other countries.[54] At the same time, McDonald's had just 230 restaurants in the Philippines, but this was roughly 50 percent more than three years before (see Figure 15), and on a percentage basis the gap between the companies was growing smaller.

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[50] Anonymous, "US Companies, Alliance Global in food project", *Business World*, Philippines, 16 January 2001, page 7.
[51] Quimpo-Espino, Margie, "Sticking it out with a clean, straightforward food venture", *Philippine Daily Inquirer*, 16 April 2001.
[52] Elsham, Robin, "Jollibee's share price trails performance", *Reuters English News Service*, 14 August 2000.
[53] Anonymous, "...But Jollibee not so bullish anymore", *Manila Standard*, Philippines, 29 October 2000.
[54] *Ibid.*

Restructuring

The next major event affecting the evolution of McDonald's in the Philippines was the government's passing the Retail Trade Liberalization Act of 2000 (Republic Act 8762), which took effect on 25 March 2000.[55] This new law removed all legal barriers to McDonald's Corporation's assuming full ownership of its business in the Philippines, including the retail operations of McGeorge Food Industries. This development, along with previously described changes in McDonald's financial reporting and the December 2000 appointment of another long-time McDonald's executive as managing director in the Philippines, fueled local speculation that George Yang had sold out to his American partner.[56] According to one press report, "the US company bought back Yang's holdings because they could not stand the fact that the Philippines is the only country in the world where McDonald's is not the No. 1 hamburger chain."[57] Yang strongly denied that he had sold his shares to the parent company, but did hint at a possible future transition by noting that day to day operations were now being handled by his son and executive vice president Kenneth S. Yang, and the new managing director, Joseph Lau. As for whether George Yang's children would eventually take over the McDonald's business, Yang said only that they must prove themselves capable. At the time, only one of his four children (Kenneth) was working with him in the McDonald's business.[58]

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[55] Basic information describing the Retail Trade Liberalization Act of 2000 may be found at the Philippines Board of Investment website: <www.boi.gov.ph/basicfacts_govpol.html>. The complete text of the Act, along with the enabling rules and regulations, may be found at: <www.chanrobles.com/otherlaws.htm>.
[56] Sun-Tapic, Vivian, "Philippines' leading brands: More golden arches sprouting all over RP", *Business World*, Philippines, 29 June 2001.
[57] Quimpo-Espino, Margie., "When to tap other people's money?", *Philippine Daily Inquirer*, 30 March 2001.
[58] Quimpo-Espino, Margie, "Sticking it out with a clean, straightforward food venture", *Philippine Daily Inquirer*, 16 April 2001.

As takeover rumors spread again in June 2001, George Yang repeated his denials that McDonald's Corporation had decided to buy him out of their joint venture, saying he still owned 50 percent of GADC and that McGeorge Food Industries would continue to hold the McDonald's franchise in the Philippines.[59] Speaking at the 20th anniversary celebration of his franchise, Yang said McDonald's will continue to expand cautiously in the Philippines, given the prevailing economic slump. He said the company planned to spend PHP 1.5 to 2.0 billion for new store openings over the next two years plus another PHP 1.5 billion for a new commissary and meat plant to be located somewhere in Luzon. He added that these funds were to come from internal sources and from borrowing, as had been agreed with McDonald's. Between 25 and 30 new stores were targeted to open in 2001, mostly in the provinces through franchising.[60] Yang also noted that cost cutting had become critical, since the fast food industry was competing on price, and added that despite the liberalization of retailing in the Philippines and a projected 10 to 20 percent increase in annual sales, new entrants need to have economies of scale to succeed.[61]

McDonald's Corporation seemed to share George Yang's views and commitment, as Jim Skinner, president of McDonald's International, and Claire Babrowski, president of McDonald's Asia-Pacific-Middle East-Africa, accompanied Yang to meet Philippines President Arroyo and informed her of the company's latest expansion plans in September 2001.[62] However, the primary purpose for their visit to the Philippines was probably not

[59] Ferriols, Des, "Yang of McDonald's RP denies selling out to US partners", *The Philippine Star*, 22 June 2001.
[60] Anonymous, "McDonald's to continue 2-yr expansion program", *Business World*, Philippines, 22 June 2001.
[61] Ferriols, Des, "Philippine fastfood industry seen to grow 10% to 20% in next 3 years", *The Philippines Star*, 27 June 2001.
[62] Villaneuva, Marichu A., "McDonald's sets P3.5-B expansion", *The Philippine Star*, 19 August 2001.

public relations, but rather to put the final touches on a complete restructuring of the company's local operations.

In its third-quarter financial reports, McDonald's Corporation revealed that there had been a restructuring of its ownership in the Philippines, effective 1 July 2001. The company press release explained, "As a result of the restructuring, most of our restaurants in the Philippines are now Company-operated rather than franchised."[63] This disclosure was made by way of explaining how Asia-Pacific sales revenues and franchise margins had increased, and company-operated margins decreased, during the third quarter 2001, thus confirming the relatively poor performance of the Philippines operation.[64] No other details were given concerning the organization or ownership structure in the Philippines. These did not appear until a month later.

On 18 November 2001 news broke that the Board of Investment Management Committee had pre-qualified McDonald's Corporation to engage in retail trade based on the requirements of the Retail Trade Liberalization Act of 2000. The recommendation from BOI had been forwarded to the Department of Trade and Industry (DTI) which gave its official approval. (The dates of McDonald's application and its subsequent approval were not reported.) According to the plan it submitted to DTI, McDonald's Corporation, through its holding company McDonald's Restaurants Operations, Inc., was to effect the merger of its 40-percent owned subsidiary in the Philippines, Golden Arches

[63] McDonald's Corporation Financial Press Release: "McDonald's third quarter global results press release", 18 October 2001, downloaded from <www.mcdonalds.com/corporate/press/index.html>.
[64] *Ibid.* As explained in the press release, the franchise margins in the Philippines were lower than average for the segment (Asia/Pacific), so converting a large number of franchised stores in the Philippines to company-owned stores had the simultaneous effects of increasing the average franchise margin along with company sales revenues for the segment (sales revenues of franchised stores are not included in the company's reported sales revenues). At the same time, the change in restaurant classification in the Philippines contributed to a decline in company-operated margins, because the company-operated margins in the Philippines are lower than the average for the segment. Thus was not just a concern about lower than average royalty rates that prompted McDonald's conversion of stores in the Philippines.

Development Corporation (GADC), and McGeorge Food Industries, Inc., with GADC to be the surviving entity.[65]

In its application, McDonald's declared the net worth of its Philippines operations to be PHP 9.204 billion (about USD 177 million), but no breakdown of net worth by company was reported.[66] Neither was the ownership structure of the post-merger GADC reported. It seems logical to conclude that GADC, as the real estate development end of the business, would have had greater capitalization than McGeorge Food Industries prior to the merger, in which case its 40 percent ownership of the pre-merger GADC probably would have given McDonald's Corporation a controlling share of GADC following the merger. This share would be even greater if McDonald's were to convert into equity any outstanding loans that it had previously made to GADC (or McGeorge Food Industries).

It was noted in the application that McDonald's would convert USD 1.5 million in receivables from McGeorge Food Industries (most likely royalty payments) into equity in the post-merger GADC. McDonald's also said that a 'proposed local partner' would put USD 1 million into the merged equity, but it did not identify the investor.[67] One source identified George Yang as the local partner to add USD 1 million in equity, which seems a bit strange given his existing ownership share in both pre-merger companies and the relatively small amount of this additional investment, which is hardly enough to ensure control of the post-merger company.[68] (Another possibility is that George Yang's son Kenneth was the unnamed partner.) The same source reported McDonald's ownership share in the post-merger GADC would be 40 percent, which seems even less likely given

[65] Cabacungan, Gil C., Jr., "McDonald's to firm up control of RP operations", *Philippines Daily Inquirer*, 18 November 2001.
[66] *Ibid.*
[67] *Ibid.*
[68] Chipongian, Lee, "McDonald's aiming for bigger bit of RP market", *The Manila Times*, Philippines, 19 November 2001.

the other known facts (this was probably just confusion with McDonald's pre-merger ownership share in GADC). Inasmuch as McDonald's Corporation's fourth quarter financial reports also contained the note: "As a result of the restructuring, most of our restaurants in the Philippines are now Company-operated rather than franchised", there remains little doubt that the parent company now owns a controlling majority in all aspects of the Philippine operations.[69]

As McDonald's Corporation assumed control of the local retail operations in mid 2001, it seems improving efficiency became a higher priority than unit expansion. In its ongoing war with Jollibee, McDonald's was understandably focused on unit expansion, but adding under-productive units does little to improve one's competitive position. McDonald's sales of PHP 8 billion in 2000 represented an average per store revenue of PHP 35.4 million. By comparison, Jollibee's sales of PHP 15.4 billion represented an average per store revenue of PHP 42.5 million.[70] While cost control is obviously one important factor in improving profitability, so is the closing of underperforming stores. During the third quarter of 2001 McDonald's shut the doors on at least eight stores, reducing the number of outlets in the Philippines from 243 as of 30 June 2001 to 231 just three months later. New store openings in the fourth quarter allowed the company to end the year with a total of 237 outlets, just two more than at the end of 2000. Over the same period, Jollibee expanded its chain from 374 to 421 stores.[71]

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[69] McDonald's Corporation Financial Press Release: "McDonald's reports global results", 24 January 2001, downloaded from <www.mcdonalds.com/corporate/press/index.html>.
[70] Chipongian, Lee, "McDonald's aiming for bigger bit of RP market", *The Manila Times*, Philippines, 19 November 2001.
[71] Jollibee Foods Corporation, "The Jollibee Group of Companies announces 2001 4th quarter and full year results", downloaded from: <http://www.jollibee.com.ph/corporate/quarterly.htm>.

McDonald's obviously has much work ahead if it hopes ever to catch up with and surpass Jollibee's position in the Philippines. Perhaps simply improving profitability is a more realistic and desirable goal. Maintaining second place in a growing market of 76 million people is not all that bad, especially if one is making money.

As for George Yang, it seems that his management involvement with McDonald's is nearly over, but that may be fine his perspective, considering his son Kenneth S. Yang has now taken his place in the spotlight as the executive vice president of GADC.[72] In the end, what may have been a takeover prompted by poor performance and an embarrassing failure to improve McDonald's competitive position in the local market was handled in a face-saving manner that suggests little more than a natural transition coming at the end of a 20-year franchise agreement. Of course, things sometimes are just as they appear.

72 Anonymous, "McDonald's covered all bases in Balayan", *Philippines Daily Inquirer*, 20 December 2001.

MALAYSIA

The Premier Partner

As the McDonald's concept was being introduced in both Singapore and the Philippines, plans were already underway for the company's next market entry in Asia, this time in Malaysia. As it turns out, persistence was probably the most important quality exhibited by McDonald's newest partner in Asia. Tan Chee Yioun entered the world on 23 February 1952, the fourth of eight children born to the owner of a small transportation company in Batu Pahat, Johor. Eager to enter the business world, Tan completed Form Five and left school to start work. In 1970 he began working as a bank clerk for United Malayan Banking Corporation, and sold life insurance part-time for American International Assurance. Within two years he quit his job at the bank and began selling insurance full time. At 21 he became the youngest AIA agency supervisor. It was about this same time he adopted the English name 'Vincent', by which he is better known today. Tan also became an avid reader, especially of business magazines, and he credits this for helping him to overcome his lack of tertiary education.[1]

After reading about McDonald's in *Time* magazine, Vincent Tan wrote to the company in 1973 and inquired about the possibility of obtaining the franchise for Malaysia. The company declined, but it did send the enthusiastic insurance man some literature. By 1976 Tan had left the insurance business and began importing cars and dabbling in real estate (along with other ventures), but he still continued to hound McDonald's. His persistence finally paid off. In 1979 McDonald's made its debut in

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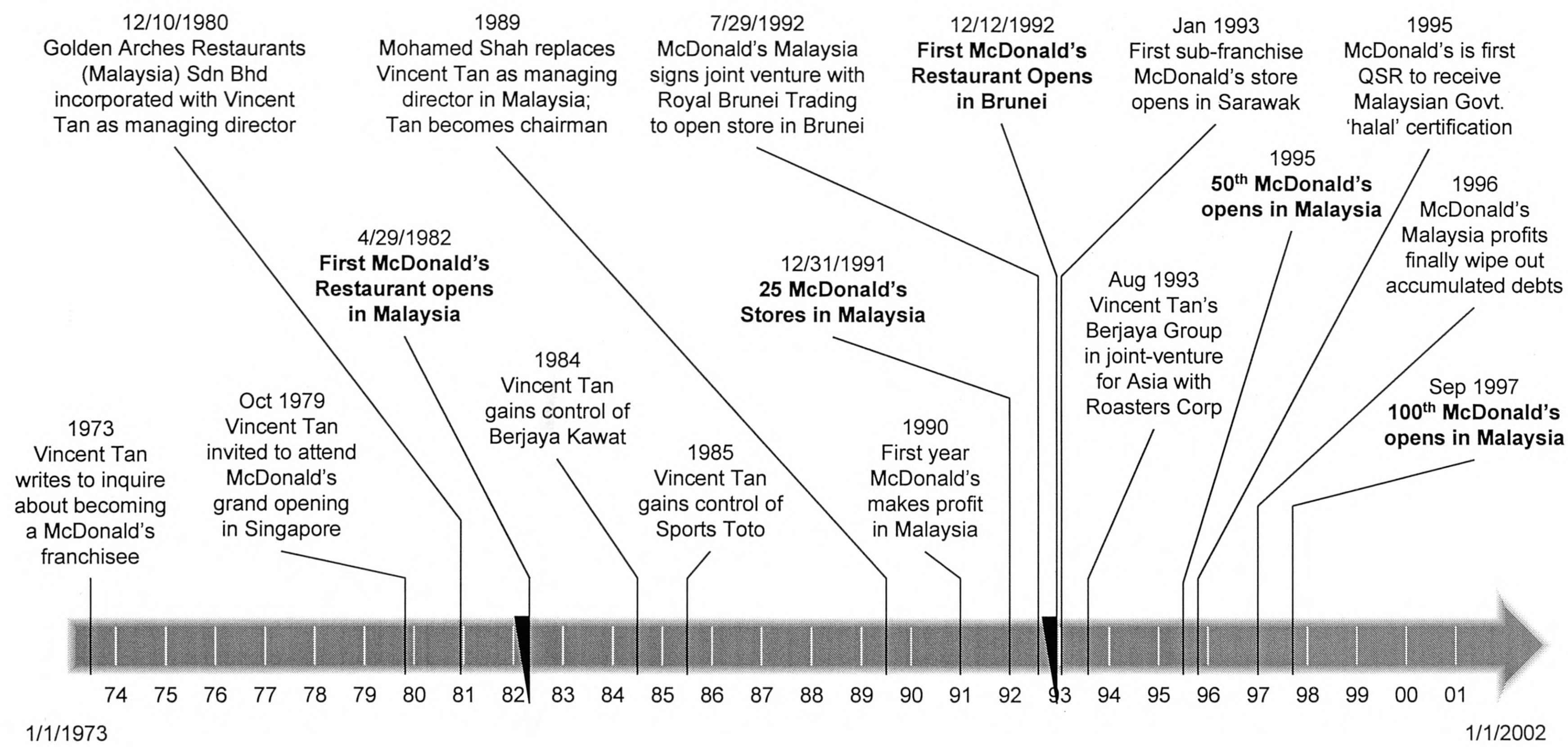
[1] Devadason, Rajen, "From burgers to billions", *Malaysian Business*, 16 December 1993, page 10.

Figure 16
McDonald's in Malaysia Timeline



Singapore and Vincent Tan was invited by the company to attend the opening. A year later, Tan had secured for himself the franchise rights for Malaysia.[2]

A local joint venture company, Golden Arches Restaurants (Malaysia) Sendirian Berhad, was incorporated on 10 December 1980 to operate McDonald's restaurants in Malaysia.[3] In accordance with local regulations, McDonald's Corporation held just a 49 percent share of the joint venture, while the other 51 percent was owned by Malaysian nationals, with Vincent Tan as the majority owner. (The source does not give the names or number of any other Malaysian owners.) Three of the seven board members were identified as Americans (obviously from McDonald's Corporation), and Vincent Tan was named as managing director.[4]

The first McDonalds's restaurant in Malaysia opened on 29 April 1982. Turnover grew throughout 1983 and 1984, and despite losses in both years, the firm was confident in expanding the business. By April 1986 there were nine outlets in Malaysia, six in Kuala Lumpur and one each in Petaling Jaya, Jahor Baru, and Seremban.[5] That number grew to 22 by the end of 1988, but then growth stagnated for a bit, as shown in Figure 17. There were still just 22 outlets at the end of 1990, which was (perhaps not coincidentally) the first year in which Golden Arches Restaurants turned a profit.[6] Modest growth then

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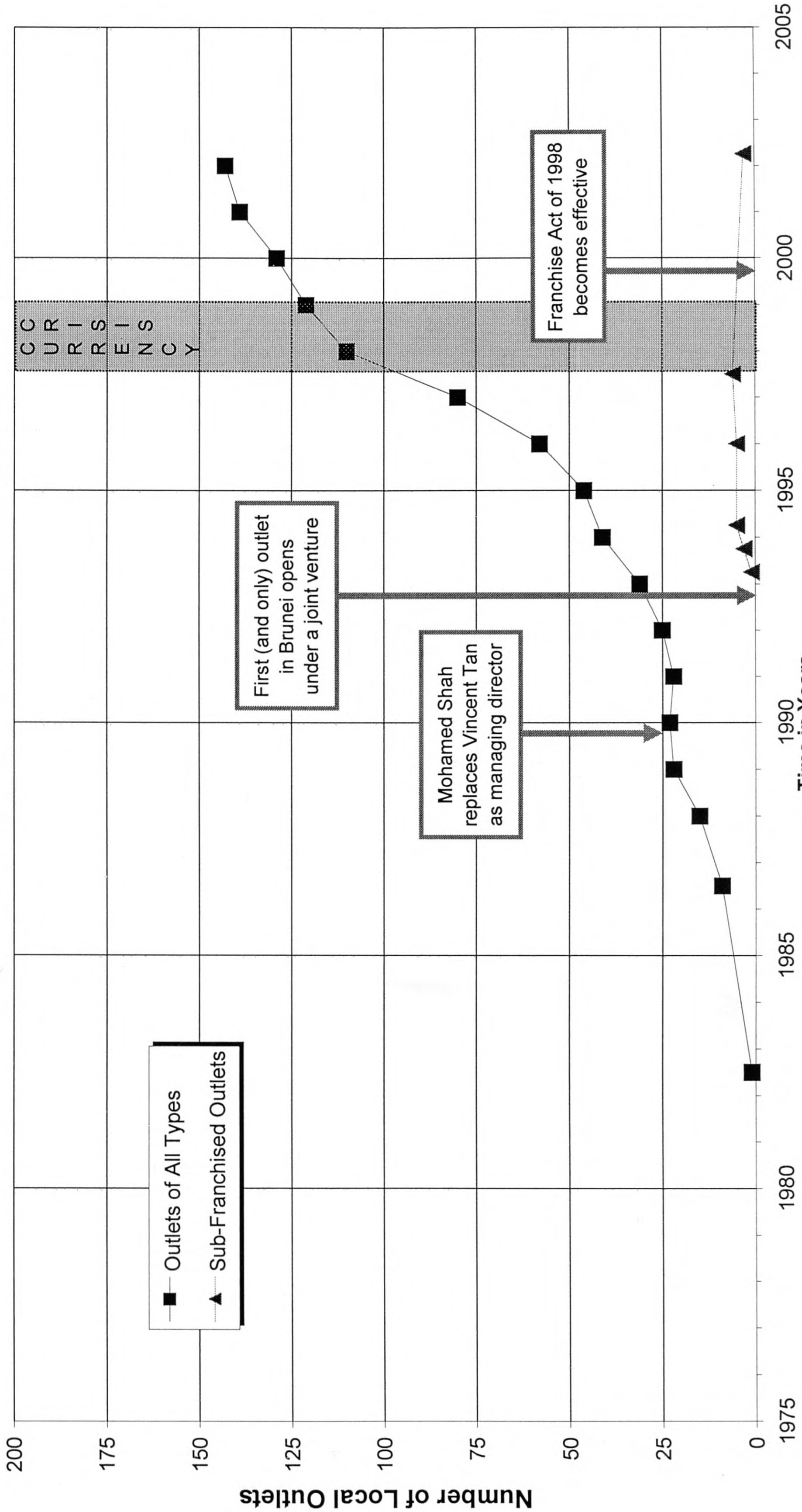
[2] Devadason, Rajen, "From burgers to billions", *Malaysian Business*, 16 December 1993, page 10.
[3] In Malaysia, the words 'Sendirian Berhad' or 'Sdn Bhd' in a firm name means 'private limited' and identifies it as a private-owned limited liability company (or corporation). A publicly-traded limited liability company simply bears the word 'Berhad' or 'Bhd', which means limited (comparable to the suffix 'Inc.' in the United States).
[4] ESCAP/UNCTC Joint Unit on Transnational Corporations, *The Socio-Economic Impact of Transnational Corporations in the Fast Food Industry*, ESCAP/UNCTC Publication Series B, No. 14, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand, 1988, Page 19.
[5] Hing Ai Yun (consultant to ESCAP/UNCTC Joint Unit on Transnational Corporations), "Malaysia: A Case Study", *The Socio-Economic Impact of Transnational Corporations in the Fast Food Industry*, ESCAP/UNCTC Publication Series B, No. 14, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand, 1988, Pages 56-57.
[6] Astbury, Sid, "KFC Malaysia: By no means chickenfeed", *Asian Business*, Volume 28, Issue 8, Hong Kong, August 1992.

Figure 17
McDonald's Unit Growth in Malaysia



resumed the following year, until by the end of 1992 there were 30 outlets that generated a turnover of MYR 77 million. With plans to add another 10 outlets, Golden Arches Restaurants was projected a record turnover of MYR 100 million in 1993.[7] However, it was not until 1996 that the company finally managed to wipe out the accumulated losses from its early years.[8]

Change at the Helm

Fourteen years to break even seems like a long time, even for McDonald's, a company known for taking a long-term, strategic view in business development matters. But perhaps the pleasure Vincent Tan displayed about his fast-food venture was less about long-term prospects than the instant corporate credibility that partnership with McDonald's had given him. In a move that was unusual for McDonald's franchisees (and strongly discouraged by the company), Tan almost immediately turned his energies to other business pursuits. In 1984 he leveraged his new-found business credibility to gain control of Berjaya Kawat Berhad (now Berjaya Industrial Berhad), a manufacturer of steel wire. Within a decade he had grown the firm more than eighty times over, creating a conglomerate with MYR 5.4 billion in assets. But his biggest break came in 1985, when he bought a 51 percent share of Sports Toto (a gambling monopoly that operates lotteries) from the Malaysian government in one of the country's first privatizations of a state-owned enterprise.[9] Several other deals followed that made Vincent Tan one of the best-known and wealthiest business figures in Malaysia. One deal that must have been especially annoying to McDonald's Corporation came in 1993,

[7] Kadir, Kartini Abd., "Golden Arches sees RM 100 M turnover", *Business Times*, Malaysia, 9 January 1993, page 2.
[8] Ng Poh Ling, "Arching towards gold", *Malaysian Business*, 1 June 1997, page 24.
[9] Devadason, Rajen, "From burgers to billions", *Malaysian Business*, 16 December 1993, page 10.

when Tan's Berjaya Group bought 11.3 percent of the Roasters Corporation, and set up a 50:50 joint venture to own, operate, and franchise Kenny Rogers Roasters Restaurants throughout Asia.[10]

Perhaps under pressure from McDonald's Corporation, Vincent Tan resigned as managing director of Golden Arches Restaurants in 1989, but he retained the position of chairman along with an ownership stake in the company. (Tan said in an interview that he later offered to resign as chairman in 1993, citing a possible conflict of interest over the Roasters deal, but gave the impression that he remained in that post.)[11] Named as the new managing director of Golden Arches Restaurants in 1989 was Mohamed Shah bin Abdul Kadir, who continues to head the business today. Although Vincent Tan is still acknowledged in the press as an owner and partner in the business, it is now Mohamed Shah who is most directly associated with McDonald's in Malaysia. He is increasingly recognized also as McDonald's joint venture partner in Malaysia (without reference to Tan), even though McDonald's Corporation has for years been identifying him as such.[12]

Mohamed Shah comes from a well-connected family in Malaysia. Both of his parents, Tan Sri Abdul Kadir and Tun Fatimah, served as cabinet ministers in the government while his brother, Ali bin Abdul Kadir, is an accountant who by 1990 had become executive chairman of Earnst & Young in Malaysia (and in early 1999 was named chairman of the Malaysia Securities Commission).[13] It is not known when

[10] Ganesalingam, E., "BGroup buys 11.3 Pc of US-based Roasters Corp", *Business Times*, Malaysia, 21 August 1993, page 7.
[11] Devadason, Rajen, "From burgers to billions", *Malaysian Business*, 16 December 1993, page 10.
[12] For three years, beginning in 1996, McDonald's Corporation included in its annual reports the names of officers and affiliates located outside the United States. The only such name listed for Malaysia was Mohamed Shah, who was identified as a McDonald's joint-venture partner. (Prior to 1996, and in the years following 1998, the company's annual reports have included only a more abbreviated listing of company directors and officers.)
[13] Anonymous, "Tough job ahead", *Malaysian Business*, 16 March 2000, page 41.

Mohamed Shah began his involvement with McDonald's, but in 1993 it was reported that he personally owned 25 percent of Golden Arches Restaurants (with Vincent Tan owning 26 percent and the balance of 49 percent being held by McDonald's Corporation).[14] This same ownership structure is often reported in the news and has apparently remained unchanged for years (at least through March 2000).[15] It seems most likely that Mohamed Shah was one of the original Malaysian owners (and perhaps the only other one) who shared a 51 percent stake in Golden Arches Restaurants with Vincent Tan, but this has not been confirmed. It is also possible that a new ownership deal was struck to give Mohamed Shah, as the new managing director, a significant equity stake in the company.

Either way, it appears Mohamed Shah had appropriate personal incentives (as desired by McDonald's Corporation) to continue growing the business. And grow it he did. As shown in Figure 17, the number of McDonald's outlets increased from just 22 outlets at the end of 1990 to 139 outlets a decade later.

The Franchising Problem

Golden Arches Restaurants initially limited its development activities to the major urban areas of West Malaysia. In 1992 the company began expanding into other areas. The first move was actually an international deal that set up a McDonald's restaurant in Bandar Seri Begawan, the capital of Brunei. It was a joint venture between Golden Arches Restaurants (Malaysia) and Royal Brunei Trading, a subsidiary of Royal Brunei Airlines that was signed on 29 July 1992.[16] Details of the agreement were not reported, except to note that the Malaysian firm was expected to contribute MYR 1.7 million

[14] Devadason, Rajen, "From burgers to billions", *Malaysian Business*, 16 December 1993, page 10.
[15] Yu Wui Wui, "Three-year IT plan to increase efficiency", *The New Straits Times*, Malaysia, 1 March 2000, page 26.
[16] Anonymous, "McDonald's in Brunei", *Business Times*, Malaysia, 30 July 1992.

towards the paid up capital of the joint venture, and would also provide the required technical and managerial expertise.[17] The first and so far only McDonald's restaurant in Brunei opened on 12 December 1992.

Other target markets included the east coast states of Peninsular Malaysia and the East Malaysian states of Sabah and Sarawak (located along with Brunei on the island of Borneo). As part of its entry strategy for these new markets, Golden Arches Restaurants decided to award franchises to individuals who would own and operate McDonald's restaurants within their local areas. Technically, these were sub-franchisees of Golden Arches Restaurants, and thus required the approval of both McDonald's Corporation and its Malaysian joint venture partners. Early in 1991, the company began advertising for local franchisees. After being selected, the individual underwent a year-long training at various McDonald's restaurants in preparation for managing their own stores.[18]

The first franchisee to complete the training was Peter Chiu, who opened an outlet in Sibu, Sarawak in early January 1993.[19] Two other franchised outlets were opened later that year. The second franchised store, and the first to be owned by a Bumiputera, was opened by Mohamad Jamarin Salleh in Kota Baru, Kuantan.[20] A third franchisee, David Ho, opened his restaurant in Kuching, Sarawak in late November 1993.[21] Two other individuals were selected to run McDonald's outlets in Miri, Sarawak and Kota Kinabalu, Sabah, both of which were scheduled to open in 1994.[22]

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[17] Anonymous, "McDonald's outlet in Brunei", *Business Times*, Malaysia, 1 March 1992.
[18] Anonymous, "More McDonald's franchisees soon", *The New Straits Times*, 8 December 1992, page 20.
[19] *Ibid.*
[20] Anonymous, "McDonald's plans 10 more outlets", *The New Straits Times*, 20 September 1993, page 20.
[21] Anonymous, "McDonald's second outlet in Sarawak", *The New Sunday Times*, Malaysia, 28 November 1993, page 6.
[22] Anonymous, "McDonald's plans 10 more outlets", *The New Straits Times*, 20 September 1993, page 20.

Golden Arches Restaurants finished 1993 with a total of 41 outlets (plus the one in Brunei), up ten from the previous year, and generated an estimated turnover of about MYR 100 million.[23] Although its expansion slowed a bit in 1994, opening just five new stores that year, the company produced a surge in new store openings during 1995 that left it with 58 outlets and turnover of MYR 128 million for the year.[24] But still only five of these outlets were operated by individual franchisees. In early 1996 the company announced that it was revising the franchising system and would be offering franchises again at the end of the year, adding this was part of its plan to expand rapidly.[25] Speaking to reporters, Mohamed Shah said the selection of franchisees would be based on strict criteria: that franchisees cannot be involved in any other business while they hold the franchise and would be required to reside in the same area as their restaurant. Further, a franchise is not automatically passed down to a franchisee's next of kin, unless he or she is found suitable to run the business.[26] In other words, he was reciting standard McDonald's policies on franchising. He also said that it would take anytime from three to six years for the franchise to turn a profit, depending on the location, and than an initial capital outlay of MYR 800,000 was required to set up an outlet.[27]

Franchising plans continued to appear in articles on McDonald's in Malaysia throughout 1996 and 1997, but there were no announcements that any new franchisees had been selected or begun operations. By April of 1997 the number of McDonald's outlets in Malaysia had grown to 83, but still only six of these were franchised (one of the

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[23] Kadir, Kartini Abd., "Golden Arches sees RM 100 M turnover", *Business Times*, Malaysia, 9 January 1993, page 2.
[24] Jeyakumar, Elaine, "Secrets of McDonald's great success", *The New Straits Times*, 24 February 1996, page 16.
[25] Jeyakumar, Elaine, "Golden Arches to offer McDonald's franchises", *The New Straits Times*, 13 February 1996.
[26] *Ibid.*
[27] *Ibid.*

original five franchisees opened a second store). As if anticipating criticism, Mohamed Shah announced plans to reach 400 outlets by the year 2000, saying that 20 to 25 percent of its new outlets would be franchised. He also admitted the company had been slow to develop its franchising system, but explained it had been conducting further analysis of local markets in preparation for a new push. The main problem, he noted, was the high capital outlay required for a McDonald's franchise, now estimated at MYR 800,000 to MYR 1.4 million.[28] Two months later, he declared "franchising will be one of our major prongs of growth for the future." He stressed that franchises would only be given to individuals who must commit themselves totally to running McDonald's business and no others. The same article reported Golden Arches Restaurants' net profits as a percentage of its turnover in the last five years (1992-1996) had averaged just three percent, along with the fact the company had taken fifteen years to break even.[29] This hardly seems an effective sales pitch. Nevertheless, in September of 1997, at the opening of McDonald's 100th outlet in Malaysia, Mohamed Shah once again said the company would re-launch its franchise system and that it wanted to franchise 25 restaurants by the year 2000.[30]

Considered together, these facts and the statements released by Golden Arches Restaurants seem designed more to appease government proponents of franchising than to attract potential franchisees – and perhaps with good reason. McDonald's had come under criticism in Malaysia for not offering more entrepreneurial opportunities through its franchising system.[31] Furthermore, in 1990 the Malaysian Government had adopted franchising as part of a national development plan to increase distributive trade and

[28] Kang Siew Li, "400 McDonald's outlets by year 2000 planned", *Business Times*, Malaysia, 19 April 1997, page 3.
[29] Ng Poh Ling, "Arching towards gold", *Malaysian Business*, Malaysia, 1 June 1997, page 24.
[30] Anonymous, "Relaunch of franchise system", *Business Times*, Malaysia, 22 September 1997.
[31] Ng Poh Ling, "Arching towards gold", *Malaysian Business*, Malaysia, 1 June 1997, page 24.

Bumiputera participation in business.[32] Golden Arches Restaurants responded in 1991 with a franchising program that by late 1993 generated but five individual franchisees, at least two of which (and possibly four of the five) were ethnic Chinese. As this did little to further the government's objectives, one may presume the company restricted its subsequent search to Bumiputera candidates. It may be (as Mohamed Shah seemed to suggest) that the company had trouble identifying any Bumiputera candidates with sufficient capital, business acumen, and patience to develop a franchise under the restrictive terms set by McDonald's Corporation. Or perhaps Golden Arches Restaurants was not really enthusiastic about franchising. There was probably no business advantage to having individual franchisees, except in the more remote and less-densely populated parts of the country, the best of which had already been taken, leaving only less attractive markets for any new franchisees. KFC, the fast-food market leader in Malaysia, had expanded to more than 230 outlets covering nearly the entire country by the end of 1997 without any franchisees. However, being a publicly traded company, one could argue (at least in theory) that KFC Holdings' shares were freely available to Bumiputera investors.

As a further complication, the Entrepreneur Development Ministry began drafting a new Franchise Act in the summer of 1996. Over the next two years there were numerous reports in the press on various details of the Act while it was still under development. Uncertainty alone may have caused Golden Arches Restaurants (and other companies) to delay their franchising plans until after the Franchise Act was finally passed in late 1998. By that time, however, the effects of the Asian financial crisis were of greater concern to both potential franchisees and franchisors alike.

[32] Sulaiman, Siti Hajjah, "Personal: Focus on franchising under the Seventh Malaysia Plan", *The Edge Communications*, Issue 113, 4 November 1996, <www.bizedge.com.my>.

The Franchise Act of 1998 did not actually come into effect until 8 October 1999 (the reason for this apparent delay is not clear). Franchising companies were then given one year to submit their applications.[33] The law was intended to promote franchise growth and provide incentives for franchise development in Malaysia, but some consider its protections of franchisee rights excessive and think it may have an opposite effect. Matthew Shay, Senior Vice President and Chief Counsel of the International Franchise Association, outlined several concerns about the law, which requires certain presale franchise disclosures, formal registration of the disclosure document, and various restrictions on the franchise relationship. "Among the more troubling aspects of the new law are provisions that would require franchise systems to make three-year financial forecasts; a provision that mandates perpetual renewal of all franchise agreements; significant penalties for termination of a franchise; and provisions that would 'pierce the corporate veil' and create personal liability for directors and officers of the franchise company for any violations of the act."[34]

As these and other details of the Franchise Act began to emerge throughout 1997, it is possible that Golden Arches Restaurants simply lost interest in franchising under the new rules. In any event, through January 2001 there had still been no reports in the Malaysian press of any new McDonald's franchisees.

What did appear in the local press, in February 1999, was an article stating that Golden Arches Restaurants had altered its business strategy "to be in line with the economic slowdown so that it can maintain its presence in the Malaysian market." The

[33] Anonymous, "Better monitoring of franchise industry with Act taking effect", New Straits Times, Malaysia, 18 October 1999.
[34] Anonymous, "Malaysia Franchise Law debated at trade show", *IFA Insider*, International Franchise Assn., Volume 5, Issue 18, 18 September 2000; from: <www.franchise.org/news/insider/09152000.asp>.

main change was to reduce its rate of expansion, with the number of new outlets planned for 1999 cut from 40 to just 15.[35] As it turned out, the number of McDonald's outlets in Malaysia increased by only 8 in 1999, from 121 outlets at the start of the year to just 129 at year's end. The company also said that it would focus its expansion plans in coming years on the Klang Valley (which includes Kuala Lumpur), where half of its existing restaurants were already concentrated. The article made no mention of franchising plans, but it did say a second outlet was being planned for Sabah, where the existing outlet, in Kota Kinabalu, had previously been franchised.[36] In May 2001, there were reportedly two outlets in Sabah, confirming that a new outlet had indeed been added to the chain, but whether or not it was owned by the same local franchisee has not been confirmed. The article also said there were five outlets in Sarawak, where at least three had been franchised previously.[37] According to the Malaysian Franchise Association, McDonald's had a total of eight franchised outlets in Malaysia in late 2001.[38] If seven of these were in East Malaysia, perhaps the eighth was the store opened by Mohamad Jamarin Salleh in Kota Baru, Kuantan.

The Value of Local Suppliers

If Golden Arches Restaurants seemed cold to the idea of franchising in Malaysia, it was certainly not averse to entering into other types of long-term business partnerships. In keeping with McDonald's philosophy, the company eschewed the model of maximum

[35] Awang, Ariff, "McDonald's changes business strategy", *Business Times*, Malaysia, 2 June 1999, page 3.
[36] *Ibid.*
[37] Anonymous, "McDonald's bullish about drive-thru outlets", *The Star*, Malaysia, 11 May 2001.
[38] Malaysian Franchise Association site: <http://birch.phpwebhosting.com/~majalah/mfa/directory.php>. According to this site, information on McDonald's franchises had last been updated on 5 November 2001; however, subsequent correspondence with Golden Arches Restaurants during February 2001 confirmed that the information (as it then still appeared) on this website was not current or correct. When the reports of eight franchised McDonald's stores was last current and correct (if ever) was not determined.

vertical integration that was so successfully employed by KFC Holdings in Malaysia.[39] It chose instead to develop a network of independent but closely allied local suppliers.

High costs and non-availability of reliable local suppliers were two big challenges facing McDonald's when it entered Malaysia. Initially, almost all equipment and furnishings had to be imported, as did most food inputs. Within a few years, local sources were developed to supply packaging materials, hamburger buns, fresh onions, and paper products, but roughly 85 percent of product content was still imported (circa 1987).[40] Over time, the imported requirements were further reduced, as McDonald's and its network of worldwide suppliers worked to develop new domestic supply sources. Further, McDonald's domestic suppliers began exporting products to other McDonald's operations throughout Asia.

As elsewhere in the region, the local beef industry in Malaysia was unprepared to meet McDonald's quantity and quality requirements. The company initially approached one of the largest local cattle ranches, located in Pahang, but it a year or two before it could supply beef in the quantities McDonald's would require.[41] Then in 1987, it was reported that McDonald's had committed to setting up it own MYR 400,000 plant to process chicken and fish fillet in 1987.[42] Actually, the plant built by one of McDonald's principal suppliers through its Malaysian joint venture company. MacFood Services Sdn

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[39] KFC Holdings Sdn Bhd holds the master franchise for KFC and Pizza Hut restaurants in Malaysia. Not only does the company own all of its KFC outlets, it also owns poultry processing plants, poultry farms, breeder farms and hatcheries, poultry feed mills, and bakery operations (and other vertically integrated businesses).

[40] Hing Ai Yun (consultant to ESCAP/UNCTC Joint Unit on Transnational Corporations), "Malaysia: A Case Study", *The Socio-Economic Impact of Transnational Corporations in the Fast Food Industry*, ESCAP/UNCTC Publication Series B, No. 14, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand, 1988, pages 64-65.

[41] *Ibid.*

[42] Seaward, N, "Hatching an export plan", *Far Eastern Economic Review*, Hong Kong, 19 November 1987, page 86 (cited in *The Socio-Economic Impact of Transnational Corporations in the Fast Food Industry*, ESCAP/UNCTC Publication Series B, No. 14, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand, 1988, page 15).

Bhd was established in 1987 and is 55 percent owned by the US-based Keystone Foods LLC, a manufacturer and distributor of frozen meat products and supplier to McDonald's in the 13 countries.[43] (The other 45 percent is Malaysian-owned.) MacFood Services is McDonald's local supplier for beef patties, fish portions, chicken patties, and bone-in chicken portions. The firm also exports its products to McDonald's operations in Hong Kong, Singapore, and Indonesia, with a value of MYR 25 million in 1992.[44] By 1995, MacFood Services' exports had grown to MYR 36 million, and were expected to top MYR 50 million in 1996, after the addition of McDonald's in Brunei and India to its list of customers. Fifty percent of MacFood Services's production in 1996 went to export markets, with most of the rest going to McDonald's restaurants in Malaysia (the company also manufactures under contract for some of the domestic supermarket operators).[45] Through October 1996, MacFood Services had invested a total of nearly MYR 12 million in its manufacturing, storage, and warehousing facilities, and had plans to invest an additional MYR 3-5 million over the next two years.[46] The company purchases all of its beef from Australia and its fish from New Zealand; its chicken is from local sources.[47][48]

Another of McDonald's principal suppliers, the Chicago-based HAVI Group LP, has also provided a variety of products and services to the company in Malaysia and elsewhere in Asia. In 1992, its local affiliate, HAVI Food Services Sdn Bhd invested MYR 4.3 million to set up the first automated bun bakery in Malaysia to supply

[43] Ibrahim, Azman, "MacFood aims for RM 50 million from exports", *New Straits Times*, Malaysia, 5 October 1996, page 22.
[44] Kadir, Kartini Abd., "Golden Arches sees RM 100 M turnover", *Business Times*, Malaysia, 9 January 1993, page 2.
[45] Ibrahim, Azman, "MacFood aims for RM 50 million from exports", *New Straits Times*, Malaysia, 5 October 1996, page 22.
[46] Anonymous, "MacFood Services (M) Sdn Bhd", *Business Times*, Malaysia, 5 October 1996, page 8.
[47] Anonymous, "McDonald's beef safe for consumption", *The Malay Mail*, Malaysia, 15 February 2001, page 16.
[48] Awang, Ariff, "McDonald's changes business strategy", *Business Times*, Malaysia, 2 June 1999, page 3.

McDonald's restaurants in the country.[49] Prior to that, McDonald's had to import buns from Singapore.[50] (Another source identified Sunshine Bread as the original bun supplier to McDonald's in Malaysia, but it is not clear whether or not this was a local supplier.[51]) By 1996 HAVI Food Services bakery in the Subang Jaya Industrial Estate also supplied buns to McDonald's restaurants in Brunei and Indonesia.

Although McDonald's still imports pies, cheese, and french fries in fully-processed form, more than 90 percent of its inputs are now sources locally.[52] Development of domestic suppliers has significantly reduced the company's costs, and helped to limit its price increases in the wake of the local currency devaluation that began in late 1997.[53] Even more important, McDonald's has helped to develop new export industries that benefit the local economy and justifiably build the company's public image. Table 3 shows at least some of the company's local suppliers (as of 1996) who also export products to McDonald's operations in other countries.

Working closely with local suppliers has also given McDonald's the ability to customize its products to suit local tastes and dietary requirements. As in other countries, McDonald's in Malaysia developed several new products that were added to its local menu. These included the McEgg sandwich, McChicken (fried chicken), chili sauce, sugar cane juice, and ice lemon tea. Interestingly, McChicken was outselling McDonald's beef burgers in Malaysia by 1998, but fried chicken was not even on the

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[49] Yusof, Mimi Syed, "Bun factory starts business in Subang", *The Malay Mail*, Malaysia, 14 January 1993, page 32.
[50] Kadir, Kartini Abd., "Golden Arches sees RM 100 M turnover", *Business Times*, Malaysia, 9 January 1993, page 2.
[51] Hing Ai Yun (consultant to ESCAP/UNCTC Joint Unit on Transnational Corporations), "Malaysia: A Case Study", *The Socio-Economic Impact of Transnational Corporations in the Fast Food Industry*, ESCAP/UNCTC Publication Series B, No. 14, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand, 1988, pages 64-65.
[52] Edwin, Joseph, "It all started with McEgg", *New Straits Times*, Malaysia, 6 May 1994.
[53] Anonymous, "Top of the menu", *Malaysian Business*, Malaysia, 1 March 2000, page 22.

menu in Singapore.[54] In addition to these standard additions, the firm also implemented a 'Fourth Flavor' program under which it has offered other specialty products, such as the Rendang Burger (1989), Samurai Burger (1992), Fish Nuggets (1992), Chicken and Egg Burger (1993), Fish Fingers (1993), Fries Twisters and Fries Shakers (1993), Prosperity Burger (1994), and Sambal Burger (1994). These items are usually placed on the menu for limited periods at strategic times, such as Hari Raya Puasa and Chinese New Year.[55]

Table 3

Exports by McDonald's Suppliers in Malaysia (in 1996)

Domestic Supplier	Products Exported	Destination Countries
MacFood Services Sdn Bhd	processed beef, fish, and chicken	Singapore, Hong Kong, India
HAVI Food Services Sdn Bhd	Buns	Indonesia
Campbell Soup Southeast Asia Sdn Bhd	Condiments	Singapore, Taiwan, Hong Kong, China, New Zealand
Tien Wah Press Sdn Bhd	packaging for chicken products	Singapore, Indonesia, Thailand, Hong Kong, Taiwan, Korea
Sekoplas Industries Sdn Bhd	plastic bags	Singapore, Philippines
Markmas Pak-Print Sdn Bhd	2 or 4 drink carrier	Singapore, Korea
Hong Kong Printing Sdn Bhd	fry, hash brown, and pie cartons, and 2 or 4 ring drink holders	Singapore, Indonesia, Thailand, Hong Kong, Taiwan, Korea, Australia, New Zealand
Scott Paper Sdn Bhd	napkins and junior roll	Singapore, Indonesia, Taiwan, Hong Kong, Korea, Japan
Guppy Plastic Industries Sdn Bhd	plastic cutlery kit, recycle and virgin in-store trays	Singapore, Indonesia, Taiwan, Hong Kong, Korea, Japan, New Zealand
Creative Packaging Sdn Bhd	hash brown bag	Singapore, Taiwan

Source: [56]

[54] Ong-Yeoh, David, "McDonald's aims to open more outlets", *Business Times*, Malaysia, 27 May 1998, page 3.
[55] Edwin, Joseph, "It all started with McEgg", *New Straits Times*, Malaysia, 6 May 1994.
[56] Ng Poh Ling, "Arching towards gold", *Malaysian Business*, Malaysia, 1 June 1997, page 24.

In 1995, McDonald's was the first quick-service restaurant to receive *halal* certification from the Islamic Affairs Division of the Malaysian Prime Minister's Department. McDonald's officials were quick to point out, however, that the company and its suppliers had been adhering to *halal* regulations since the chain opened in 1982.[57] Interestingly, when the Brunei Ministry of Religious Affairs began a review of food products used by restaurants throughout the country in June 1998, it halted all McDonald's imports of beef and chicken over concerns the food might not meet *halal* requirements. This was done despite the fact the food came from the same plants McDonald's uses in Malaysia. For some reason, the authorities in Brunei would not recognize Malaysia's certification, but insisted on conducting their own investigation. They seemed to be in no hurry, as their investigation of McDonald's was not expected until August or September. Meanwhile, McDonald's sales in Brunei dropped by half, as the firm was limited to serving only its Filet-o-Fish and McEgg sandwiches.[58] It was not clear from the article whether other chains in Brunei suffered a similar fate.

What Crisis?

Unlike the other McDonald's operations in Southeast Asia, Golden Arches Restaurants appears to have successfully weathered the financial crisis and economic downturn that struck the region the late 1990s without any change in its ownership structure.

By the time the crisis hit, McDonald's had already grown to secure a solid second place standing in the local fast food market. According to a Jardine Fleming report, the

[57] Kaur, Jeswant, "McDonald's gets 'halal' certificate", *The Malay Mail*, Malaysia, 6 July 1995m page 37.
[58] Anonymous, "Brunei McDonald's without burgers", Meat Industry Internet News Service, 18 July 1998, downloaded from <www.spcnetwork.com/mii/1998/980744.htm>

market leader in Malaysia at the end of 1996 was KFC with a 57 percent share, followed by McDonald's with 24 percent share (tied for third place were A&W and Pizza Hut with 8 percent each).[59] A report in April 1997 quoted Mohamed Shah as saying, "Today, we have some 33 percent of the local fast food market.[60] Others estimated McDonald's share of the market at 30 percent in mid 1998, compared with about 50 percent for KFC.[61] Whatever the exact number, McDonald's was in a reasonably strong market position in Malaysia and, unlike the Philippines, had no serious rivals in the hamburger segment.

Golden Arches Restaurants' turnover had grown to MYR 128 million by 1995, generated from its cumulative investments of MYR 65 million.[62] Over the next year, the chain grew from 58 to 80 outlets, and its sales increased to MYR 164 million. Another 30 outlets were opened in 1997, and plans were announced for another 40 outlets to be added during 1998 at an average cost of about MYR 1.5 million. Among all McDonald's operations in Southeast Asia, Malaysia ranked second only behind Singapore in terms of sales and profitability.[63]

Perhaps the dramatic growth that began in 1995 (see Figure 17) was facilitated by a management restructuring that took place that year. In September 1995 several new executives were appointed by Golden Arches Restaurants. Among these was Ng Su Onn, an MBA graduate from Cranfield School of Management, who was named as executive director and member of the board. Others new hires included a marketing director,

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[59] Amin, Iszudin Mohd., "As dishy as ever", *Malaysian Business*, Malaysia, 1 March 2000, page 16.
[60] Kang Siew Li, "400 McDonald's outlets by year 2000 planned", *Business Times*, Malaysia, 19 April 1997, page 3.
[61] Ng Poh Lig, "No slowing down", *Malaysian Business*, Malaysia, 16 July 1998, page 11.
[62] Jeyakumar, Elaine, "Secrets of McDonald's great success", *The New Straits Times*, Malaysia, 24 February 1996, page 16.
[63] Ong-Yeoh, David, "McDonald's aims to open more outlets", *Business Times*, Malaysia, 27 May 1998, page 3.

accounting manager, and public relations manager (all of whom were women).[64] Mohamed Shah remained in place as managing director, and it was about this time that press reports (and McDonald's Corporation) began to identify him as McDonald's joint-venture partner in Malaysia. Whether or not special significance should be ascribed to this last observation, it seems clear that Golden Arches Restaurants had revamped it management structure in preparation for more aggressive growth in the future.

From all this evidence, it appears that the company was well prepared to face to the new challenges that were brought on by the currency and financial crises that began in late 1997. The Malaysian Ringgit, which for years had been stable in a range of MYR 2.4 to 2.7 per US Dollar, began to lose value during the second half of 1997. By mid September it had fallen to MYR 3.0 per US Dollar, and by year's end was down to MYR 3.9 per US Dollar. Its value dropped as low as MYR 4.6 per US Dollar in early January 1998 before finally beginning to recover. However, the currency never regained all of its lost value. Over the next six months the Ringgit fluctuated in the range of MYR 3.5 to 4.2 per US Dollar, and its volatility remained a serious concern until the Malaysian government imposed limited capital controls and fixed the value of the Ringgit at about MYR 3.80 per US Dollar in early September 1998 (35 percent lower than in July 1997). Although this controversial move did help to stabilize local economic conditions in the Malaysia, it did not reverse the effects of the currency devaluation; nor did it isolate the country from the impacts of subsequent regional and global economic slowdowns.

In response to the initial economic downturn resulting from the 1997 crisis, McDonald's was forced not only to slow its rate of growth in Malaysia, adding just 19 stores during 1998 and 1999 (compared to 30 in 1997), but also to cut operating costs and

[64] Kaur, Jeswant, "McDonald's Malaysia", *The Malay Mail*, Malaysia, 14 September 1995, page 33.

reduce prices to maintain its competitive position in the market. Everyone in the fast food industry had experienced slower growth and higher costs as a result of the crisis, but McDonald's in particular suffered from the currency devaluation, as it was still importing many of its requirements, including beef and fish (in unprocessed form), pies, cheese, and fries.[65] [66] As a result, Golden Arches Restaurants was forced to raise its prices 10 to 15 percent, something which others in the industry did as well. It also introduced new products, such as McSaver, the cheapest value meal on its menu.[67]

The Malaysian economy did not suffer as much from the financial crisis as some of the other Southeast Asian economies, thanks partly to its large export-oriented manufacturing sector. However, when the American economy began to slow during the second half of 2000, Malaysia suffered a corresponding decline in its export-driven economy. In the twelve months to October 2001, industrial production in Malaysia fell by 9.0 percent.[68] The effects of this are reflected in McDonald's expansion during this period: while the chain grew by 10 outlets in 2000, to a total of 139 stores, only four stores were added in 2001.

In another development, some of the outlets which had been sub-franchised to individuals in Malaysia were either closed or converted to company-owned stores during the last few years. According to information obtained from Golden Arches Restaurants in February 2002, there were "about 2" individual franchisees, both located in East Malaysia, with a total of "about 3" franchised stores (out of then 143 outlets). It was also

[65] Awang, Ariff, "McDonald's changes business strategy", *Business Times*, Malaysia, 2 June 1999, page 3.
[66] Anonymous, "Top of the menu", *Malaysian Business*, Malaysia, 1 March 2000, page 22.
[67] Amin, Iszudin Mohd., "As dishy as ever", *Malaysian Business*, Malaysia, 1 March 2000, page 16.
[68] Anonymous, "Emerging market indicators", *The Economist*, US Edition, 5 January 2002, page 86.

confirmed that the company is now "actively seeking new franchisees in Malaysia".[69] The report of eight franchised outlets as of November 2001 (by the Malaysian Franchise Association, as previously cited) was obviously based on out of date information, unless some of these franchises had actually been awarded to businesses rather than individuals. However, subsequent correspondence with Golden Arches Restaurants confirmed that no franchises have been awarded to (or franchise-type alliances signed with) any businesses in Malaysia.[70]

Although franchise awards were limited to individuals, other types of alliances were formed with various businesses to gain access to prime real estate locations. Since 1996, Golden Arches Restaurants has been developing an increasing number of outlets in non-traditional locations, such as university campuses, commercial and industrial parks, and gasoline stations. The firm was especially keen about drive-through stores, several of which had been located along major expressways, and sees these as its main revenue contributors in the long run. In May 2001 Mohamed Shah said that the McDonald's 10 existing drive-through outlets (out of a then total 141 stores) contribute 15 percent to its total sales, and he expected the contribution from drive-through stores would increase to 40 - 45 percent within three years, as the company proceeded with its plans to build 8 to 10 new drive-through restaurants each year.[71] [72] Two months earlier, McDonald's opened its eighth drive-through store in Malaysia, which was also the first in a new partnership

[69] Email correspondence received from "Meyya" at <franchising@mcdonalds.com.my> in response to questions on the current status of Golden Arches Restaurants' franchising program, 27 February 2002.
[70] Email correspondence received from "Meyya" at <franchising@mcdonalds.com.my> in response to follow-up questions on Golden Arches Restaurants' franchising program, 2 March 2002.
[71] Anonymous, "McDonald's bullish about drive-thru outlets", *The Star*, Malaysia, 11 May 2001.
[72] Anonymous, "McDonald opens first 'drive-thru' in Seremban", *New Straits Times*, Malaysia, 11 May 2001, page 25.

with Mobil.[73] Details of this partnership were not made public, but it was confirmed that this outlet is owned and operated by Golden Arches Restaurants (rather than by Mobil).[74] McDonald's has made similar deals with both property developers and other retailers in Malaysia, all of which seem to be primarily about gaining access to prime locations, and not related to any specific co-branding strategy.

Aside from slowing its rate of expansion, shifting its emphasis to less expensive suburban store locations (which may reflect nothing more than a preference for the drive-through format), and forming alliances with other businesses as a means of gaining access to prime real estate, McDonald's appears to have made few strategic changes as a consequence of more difficult economic conditions that have prevailed since 1997. And perhaps most significant, at least in comparison to McDonald's operations in other Asian countries, is the fact there had been no change in ownership of the local joint-venture company during this period. Perhaps the local owners, Mohamed Shah and Vincent Tan, have remained financially solvent and committed to running and growing the business in a manner compatible with McDonald's own objectives. Alternatively, there may still be government restrictions on foreign ownership (which had initially limited McDonald's to 49 percent ownership) that prevent a buyout or dilution of the locals' share. With the twentieth anniversary of McDonald's in Malaysia approaching, it will be interesting to see how this partnership develops in the future.

[73] Anonymous, "McDonald's teams up with Mobil", *The Malay Mail*, Malaysia, 11 April 2001, page 22.
[74] Golden Arches Restaurants specifically denied that the outlet opened in partnership with Mobil in April 2001 was franchised. Email correspondence received from "Meyya" <franchising@mcdonalds.com.my> in response to follow-up questions on Golden Arches Restaurants' franchising program, 2 March 2002.

TAIWAN

A Delayed Entry

After Malaysia, McDonald's next Asian market entry came in Taiwan. The company had first become interested in Taiwan in the late 1970s, but government restrictions then prohibited foreign enterprises from entering the food service or food-processing industries on the grounds that such investments did not conform to government objectives of promoting higher efficiency and exports.[1] Despite this obstacle, the market remained attractive in the early 1980s for three reasons. First, there was still a U.S. military presence in Taipei, along with a sizeable American community. Second, a large number of Taiwanese had firsthand experience of the United States (and therefore of McDonald's), having worked or studied there. Third, a growing number of upper-middle-class children in Taiwan also had cross-cultural experience, many of whom had at least one parent who was educated in the United States.[2]

After seven years of negotiations, McDonald's was finally able to persuade authorities in Taiwan to let it operate there.[3] McDonald's became the first foreign food enterprise allowed to enter the country in part because of its record of high standards in hygiene and production, which by then had been successfully demonstrated elsewhere in Asia.[4] Perhaps even more important, McDonald's made commitments to use local agricultural products for its restaurants in Japan and Southeast Asia. In September 1982,

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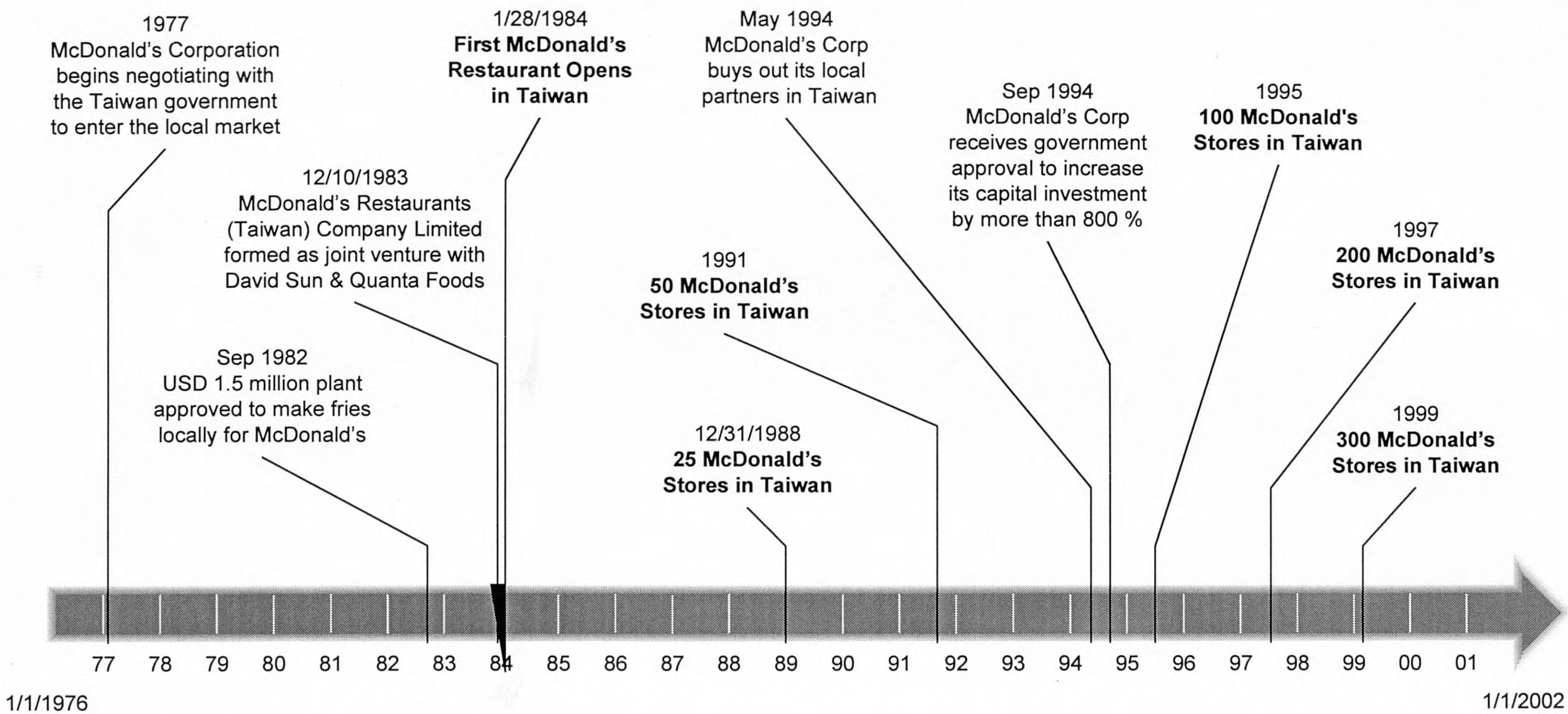
[1] ESCAP/UNCTC Joint Unit on Transnational Corporations, *The Socio-Economic Impact of Transnational Corporations in the Fast Food Industry*, ESCAP/UNCTC Publication Series B, No. 14, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand, 1988, Page 14.
[2] Wu, David H.Y., "McDonalds in Taipei: Hamburgers, Betel Nuts, and National Identity", Chapter 3 in *Golden Arches East: McDonald's in East Asia*, edited by James L. Watson, Stanford University Press, Stanford, California, 1997, page 120-121.
[3] ESCAP/UNCTC Joint Unit on Transnational Corporations, *op.cit.*, page 14.
[4] Wu, David H.Y., *op.cit.*, pages 120-121.

Figure 18
McDonald's in Taiwan Timeline



McDonald's received permission to construct a local food processing plant at a cost of USD 1.5 million to make french fries from Taiwan potatoes. It also agreed in principle to purchase Taiwan flour, tomatoes and onions.[5] (Later reports say that the company came to regret its decision to use local potatoes, as they resulted in 'soggy' fries[6]). One other factor in McDonald's favor was its commitment to having a local partner, which ensured at least half of the profits from business venture would remain in Taiwanese hands.[7]

On 10 December 1983, McDonald's Corporation signed an agreement with David Sun, a Taiwanese businessman and president of Quanta Foods Limited, to form a local joint venture company.[8] Under their agreement, McDonalds Corporation owned 50 percent of McDonald's Restaurants (Taiwan) Company Limited; the other 50 percent was controlled by David Sun (through Quanta Foods Limited).[9] Details about the ownership of Quanta Foods Limited at that time could not be found, but later press articles identified several other people as having been associates or partners of David Sun in the McDonald's business. These included his brothers, Andrew and John Sun, along with Tim Lai, and Tony Pang.[10] [11] However, David Sun alone is most often identified as McDonald's partner in Taiwan.

McDonald's Restaurants (Taiwan) Company Ltd. opened its first store in Taipei, Taiwan on 28 January 1984. The following month it set a record for weekly sales among

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[5] Anonymous, "McDonald's to set up food processing plant in Taiwan", *Dow Jones Newswires*, Dow Jones News Service, 16 September 1982.
[6] Shao, Maria, "In Taiwan, fast food is fashionable, even if the french fries are a bit soggy", *Wall Street Journal*, Eastern Edition, 2 December 1985.
[7] ESCAP/UNCTC Joint Unit on Transnational Corporations, *op. cit.*, page 14.
[8] ESCAP/UNCTC Joint Unit on Transnational Corporations, *op. cit.*, page 10.
[9] Shao, Maria, "In Taiwan, fast food is fashionable, even if the french fries are a bit soggy", *Wall Street Journal*, Eastern Edition, 2 December 1985.
[10] Rae, Sheila, "Beijing's franchise revolution", November 2000; from <www.amcham-china.org.cn>.
[11] Kramer, Louise, "Boston Chicken Inc. hatches foreign expansion company", *Nation's Restaurant News*, New York, Volume 31, Issue 3, 20 January 1997.

all McDonald's restaurants worldwide. By December 1985 McDonald's had seven outlets in Taiwan, and three more outlets were under construction.[12] Five years later (at the end of 1990), the company had expanded to 43 outlets and its pace of growth was increasing, as shown in Figure 19. By December 1992 there were 67 outlets in Taiwan, a 56 percent increase over two years before.[13]

The flood of media reports publicizing the success of McDonald's in Taiwan apparently had one unanticipated result. On 29 April 1992, two bombs exploded at McDonalds restaurants in Taipei and Kaohsiung, killing a policeman and injuring four other people (two seriously). Police later said the explosions occurred about 10 hours after extortionists demanded TWD 6 million (about USD 240,000) from the chain.[14] McDonald's responded by closing all 57 outlets in Taiwan for several days while the matter was under investigation. KFC, another target of the extortionists, did the same.[15] As it turned out, there was no political motive for bombings (as some foreign reports had initially conjectured). Rather, it was the work of local extortionists and racketeers who typically prey on Taiwanese businesses and wealthy families. As anthropologist David Y.H. Wu explained, "In a sense, the bombing shows that McDonald's is now treated like any other business in Taiwan, more a target of opportunity than a symbol of oppression."[16]

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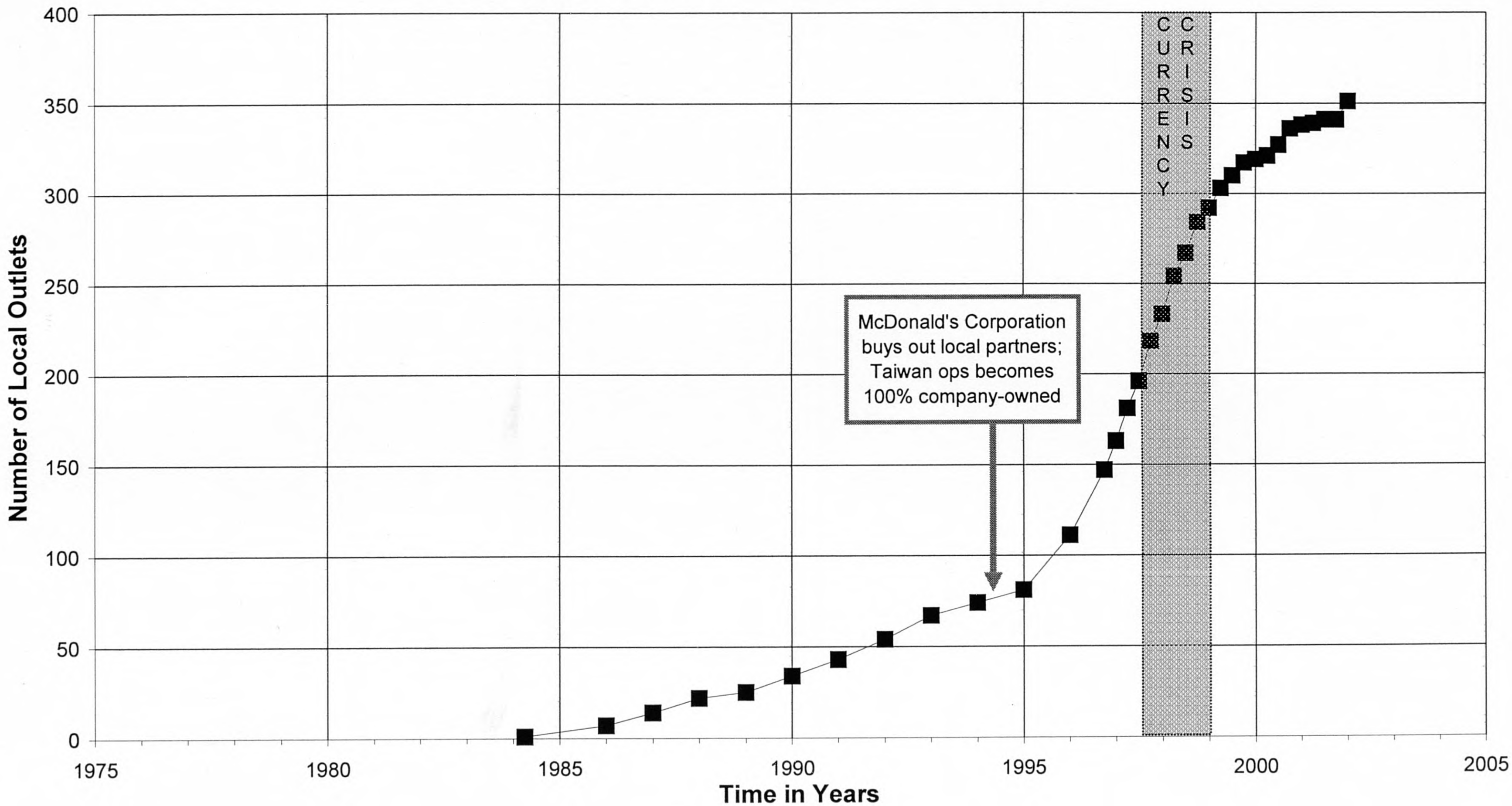
[12] Shao, Maria, "In Taiwan, fast food is fashionable, even if the french fries are a bit soggy", *Wall Street Journal*, Eastern Edition, 2 December 1985.
[13] McDonald's Corporation 1995 Annual Report.
[14] Anonymous, "Kentucky Fried Chicken closes Taiwan outlets", *Wall Street Journal*, 1 May 1992.
[15] Anonymous, "MCD, KFC suspend Taiwan operations after bombings", *Nation's Restaurant News*, 11 May 1992.
[16] Wu, David H.Y., *op. cit.*, pages 122-123.

Figure 19
McDonald's Unit Growth in Taiwan



In that context, it must have been a particularly tempting target. By 1993 McDonald's annual turnover in Taiwan reached TWD 3.6 billion (USD 144 million); and based on second quarter results, its turnover in 1994 was projected to top TWD 4.5 billion (USD 180 million). The average revenue per outlet exceeded USD 2.2 million, and the company had a 50 percent share of the rapidly expanding fast food market in Taiwan.[17]

An Early Departure

Despite their apparent success, David Sun and his associates decided to sell Quanta Food's total share in the joint venture to McDonald's Corporation in May 1994.[18] McDonald's then reorganized the local company and appointed Bill Rose, an American executive with international experience, as its new chairman in Taiwan.[19] Although the reasons for this takeover were not elaborated, there seem to be two possible explanations.

The first possibility is that David Sun and his associates at Quanta Foods became more interested in pursuing other business opportunities, which would have violated the spirit, if not strictly the letter, of the franchise conditions in the joint venture agreement. McDonald's Corporation may also have become more sensitive about this issue after its experience with Vincent Tan in Malaysia. This theory is supported by the fact that David Sun and other individuals associated with Quanta Foods were soon involved in other food venture in China and Taiwan. Andrew Sun (reportedly with help from his brother David) brought the T.G.I. Friday's concept to Taiwan, and by November 1996 was operating

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[17] Anonymous, "Taiwan's McDonald's: Expanding to 400 outlets by 2000", *Dow Jones Newswires*, Dow Jones International News, 13 September 1994.
[18] McDonald's Corporation, 10-K filing for 31 December 1995.
[19] Wu, David H.Y., *op. cit.*, page 121.

seven restaurants in Taiwan and another in Beijing.[20] John Sun then signed a deal with Boston Chicken, Inc. in January 1998 to introduce its Boston Market concept in both Taiwan and China (making use of a USD 50 million loan from Boston Chicken to help built the chain).[21] [22] Meanwhile, Tim Lai had become president of McDonald's Beijing, and Tony Pang became regional manager for KFC in Beijing.[23] As for David Sun, after selling out his stake in McDonald's Taiwan, he spent a year with Hard Rock Café in Taiwan and sought other franchise opportunities in mainland China.[24] In 1999 David obtained the franchise rights for Starbucks in Beijing, which he operates under the name Mei Da Coffee Company Limited.[25]

A second possible explanation for the takeover is that McDonald's Corporation wanted to expand more rapidly than David Sun (or his partners) was willing or able to support. Several of McDonald's international competitors, including KFC, Wendy's, Burger King, and Hardee's, also entered Taiwan in the 1980s, and it was important for the company to defend its 50 percent share of the rapidly growing fast-food market.[26] In September 1994, McDonald's Restaurants (Taiwan) Company, now a wholly-owned subsidiary of McDonald's Corporation, announced that it had obtained the government's approval to increase its capital to TWD 880 million from TWD 102 million. This was the largest ever capital increase (equivalent to USD 31 million) for a food company in

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[20] Casper, Carol, "Breaking China", *Restaurant Business*, New York, Volume 95, Issue 16, 1 November 1996, page 125.
[21] Raabe, Steve, "Boston Chicken Inc. plans restaurants in China, Taiwan", *Denver Post*, Colorado, 9 January 1997.
[22] Kramer, Louise, "Boston Chicken Inc. hatches foreign expansion company", *Nation's Restaurant News*, New York, Volume 31, Issue 3, 20 January 1997.
[23] Rae, Sheila, "Beijing's franchise revolution", November 2000; from <www.amcham-china.org.cn>.
[24] *Ibid.*
[25] Anonymous, "Beijing Starbucks customers to enjoy free web access", press release by SOHU.com, dated 11 October 2000; from <www.yahoo.com/prnews/001011/sohu_com_p.html> on 29 January 2001.
[26] Anonymous, "Taiwan's McDonald's: expanding to 400 outlets by 2000", *Dow Jones Newswires*, Dow Jones International News, 13 September 1994.

Taiwan. The money was used as working capital to expand the business and to help relieve the company's interest burden.[27] McDonald's expansion plans called for a total of 100 outlets in Taiwan by the end of 1995 (there were 77 at the end of 1993), with the further goal of reaching 400 outlets by the year 2000.[28] Perhaps David Sun and his associates lacked the necessary capital to support such aggressive plans, or were unwilling to invest so heavily in what was certainly a long-term proposition.

The fact David Sun and his partners at Quanta Foods had sold out their stake in McDonald's Taiwan did not seem to have an adverse affect on the firm's performance. McDonald's revenues in Taiwan grew 30 percent from January to June 1995.[29] By the end of 1995 there were 111 McDonald's outlets throughout Taiwan, which exceeded the company's goal of 100 outlets set in mid 1994. A year later the chain had grown to 163 outlets, and by the end of 1997 there were 233 McDonald's outlets in Taiwan. The pace of expansion slowed a bit in the wake of the Asian financial crisis that began in 1997 (as shown in Figure 19), but the company still managed to open 105 new outlets over the next three years, and finished the year 2000 with 338 restaurants in Taiwan.[30] This represents an average annual growth rate of over 25 percent since the local operations were taken over by the parent company in mid-1994.

Most of this growth came in the form of company-owned stores. Although McDonald's began offering franchise opportunities in Taiwan several years earlier, by

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[27] Anonymous, "McDonald's to boost capital to NT$ 800 M from NT$ 102 M", *Dow Jones Newswires*, Dow Jones News Service - Ticker, 13 September 1994.
[28] Anonymous, "Taiwan's McDonald's: expanding to 400 outlets by 2000", *Dow Jones Newswires*, Dow Jones International News, 13 September 1994.
[29] Anonymous, *Taiwan Food Market Report*, USDA/Foreign Agricultural Service, 30 July 1995. <www.agroindia.org/world/usda/taiwan.htm>.
[30] McDonald's Corporation, Financial Press Release: Fourth Quarter and Year End 2000, 24 January 2001.

November 2001 there were still just 12 franchised outlets in the country.[31] According to the company, these 12 franchised stores were operated by 11 individual owner/operators. In addition to the main cities of Taipei and Kaohsiung, franchised outlets were also located in Tao-Yuan, Ping-Tung, Yun-Lin, Yi-Lan, Nan-Tou, and Miao-Li counties. The company also said, "We are carefully seeking new franchisees in Taiwan to maintain our standard Q.S.C.&V." (McDonald's famous shorthand for quality, service, cleanliness and value).[32] No other information was provided as to the identity or background of these individual franchisees. However, with a total of 351 McDonald's outlets in Taiwan at the end of 2001, it is clear that franchising has not been a major factor in the firm's growth or its dominant position in the local market. Taiwan is one place in Asia where McDonald's seems to have achieved even greater success on its own, than with a local partner.

[31] Anonymous, "KFC to allow franchise stores in Taiwan", *Taipei Times*, 20 November 2001.

[32] Personal email correspondence received from <franchising@mcd.com.tw> in response to questions sent to McDonald's Restaurants (Taiwan) Company Limited concerning the current status of their franchising program.

THAILAND

Choosing a Partner

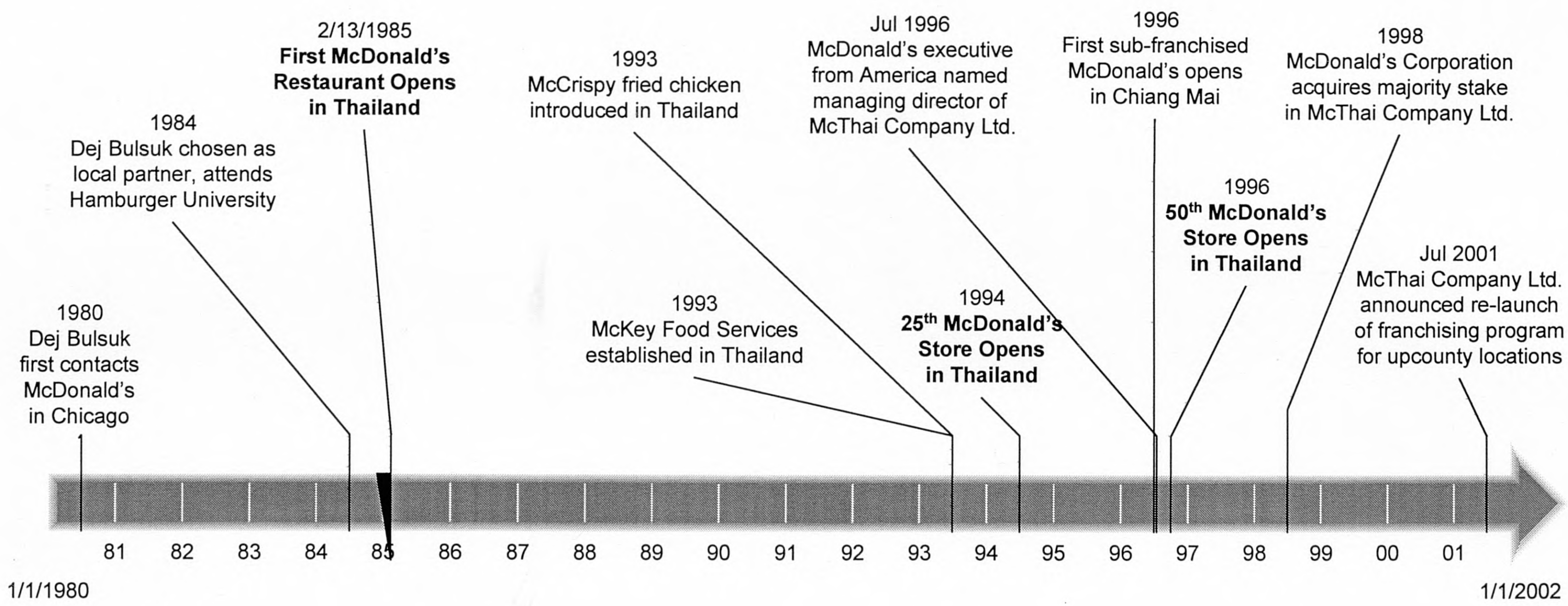
Although not the first, McDonald's has arguably been the most successful burger chain to enter the Thai fast-food market. As elsewhere in Asia, much of its success has been attributed to the firm's careful selection of a local partner.

At first glance, Dej Bulsuk seems a rather unlikely choice. His youthful passion was not business, but playing the piano and composing music. The Thammasat University graduate has said it was never his ambition to own a McDonald's franchise, and that the relationship started through a simple coincidence. Dej was visiting the United States in 1980 when he and a friend happened to drive past McDonald's corporate headquarters in Oak Brook, Illinois.[33] Familiar with the chain from his time as an American Field Services high-school exchange student in Newport Beach, California (1968-1969), Dej casually stopped in to ask when Thailand would be getting McDonald's, and to express an interest in the business. He persisted in his requests and three years later was invited to a Bangkok meeting for Thais interested in McDonald's.

Persuading McDonald's executives in the United States to select him as their business partner was not easy, however. Dej says he finally went to Chicago for an interview and won them over with a quirky reply to the question, 'What would you do if we gave you McDonald's?' He immediately answered, "If you gave me McDonald's, I would give you a Big Mac." Asked to explain, he said: "B stands for best, I for integrity, G for growing the firm, M for making money, A for being aggressive, and C for commitment to customers, staff, and partners." Soon thereafter, Dej quit his job working

[33] In Thailand it is both customary and proper to refer to individuals by their first or given name; the second or family name is frequently omitted when the specific identity of the subject has already been established.

Figure 20
McDonald's in Thailand Timeline



for the Voradej Partnership, a trading company in Bangkok, and accepted McDonald's invitation to visit Hong Kong for a one-week 'on-the-job evaluation' during which he had to work in the kitchen, take orders, serve customers, check stocks and clean the floor to test his attitude. After passing that evaluation, he attended McDonald's Hamburger University in 1984, and then spent additional time as a trainee in Arizona.[34]

Upon his return to Bangkok, Dej Bulsuk and McDonald's Corporation formed a local joint-venture company, McThai Company Limited, which was awarded a 25 year license to operate the McDonald's chain in Thailand.[35] McDonald's Corporation owned 49 percent of the joint venture, with Dej Bulsuk controlling the other 51 percent.[36] There is some confusion as to whether or not Dej personally owned this entire 51 percent stake in the company, as he later said that he had offered some shares in the new company to friends and associates.[37] Whether or not others were initially involved, Dej Bulsuk reportedly invested THB 2 million of his own money, along with another THB 55 million (then equivalent to USD 2.2 million) borrowed from a local finance company, to set up the first McDonald's store in Thailand.[38]

Building the Organization

The first McDonald's restaurant in Thailand opened in Bangkok on 23 February 1985. It was not until December 1986 that a second outlet opened. The company's

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[34] Jitpleecheep, Sukanya and Parnsoonthorn, Krissana, "Big Macs are more than mere burgers", *Bangkok Post*, Thailand, 1 March 1999.
[35] Rungfapaisarn, Kwanchai, ""McDonald's franchises on offer", *The Nation*, Thailand, 11 July 2001.
[36] Hongladarom, Chira, *et al.* (consultants to ESCAP/UNCTC Joint Unit on Transnational Corporations), "Thailand: A Case Study", *The Socio-Economic Impact of Transnational Corporations in the Fast Food Industry*, ESCAP/UNCTC Publication Series B, No. 14, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand, 1988, pages 184-187.
[37] Plengmaneepun, Suphaphan, "Think big is the way to success", *Bangkok Post*, Thailand, 20 April 1998.
[38] Jitpleecheep, Sukanya and Parnsoonthorn, Krissana, "Big Macs are more than mere burgers", *Bangkok Post*, Thailand, 1 March 1999.

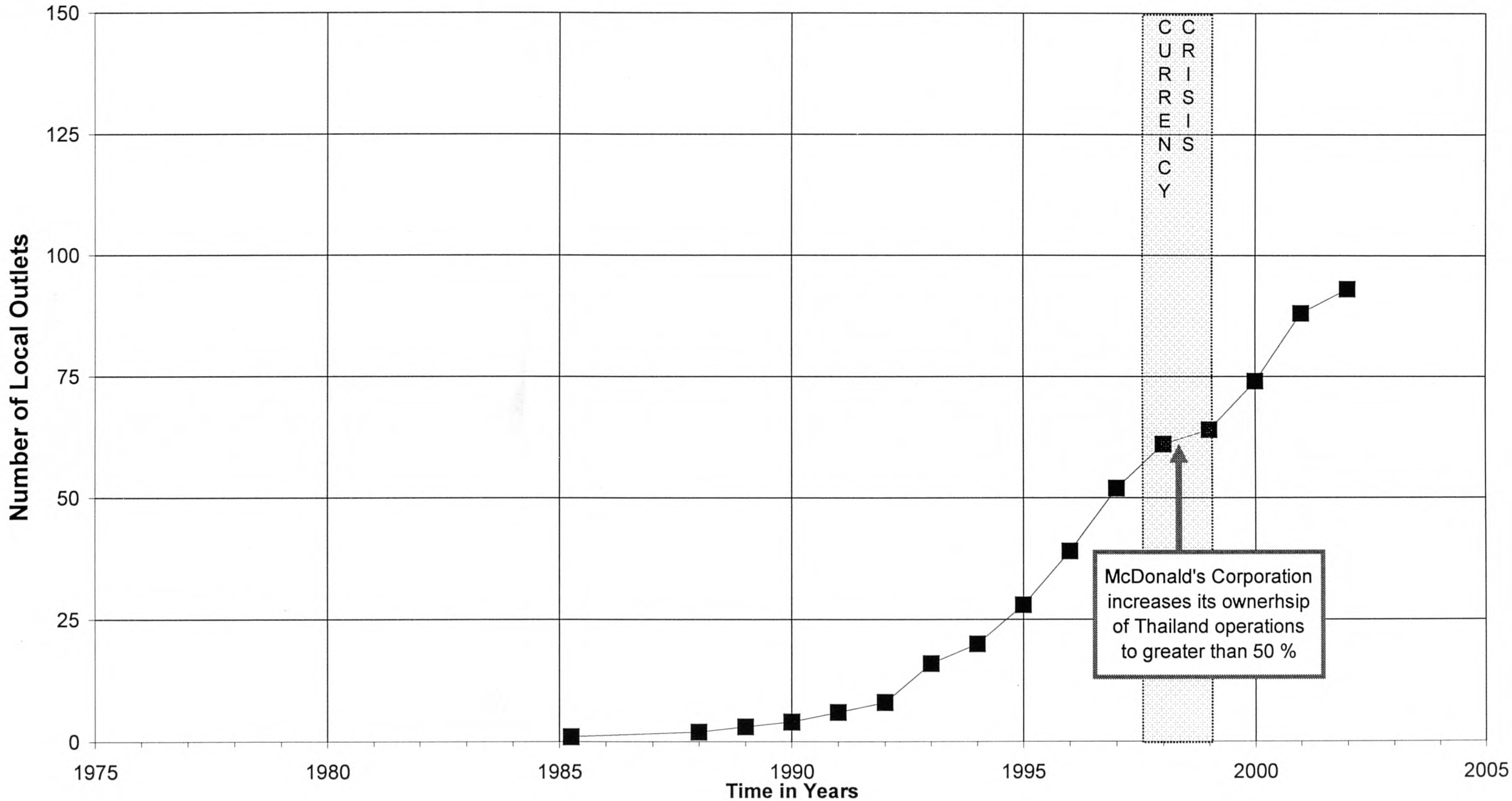
initial five-year plan called for the opening of just one additional outlet each year.[39] In keeping with this plan, there were still only eight McDonald's outlets in Thailand at the end of 1991. After that, however, the pace of expansion accelerated, as shown in Figure 21. In the next four years the chain grew at an average annual rate of nearly 50 percent, reaching a total of 39 outlets by the end of 1995. This represents an important transition, as it finally gave the local operation the critical mass required to support a network of local suppliers that could help reduce its costs and facilitate more rapid growth.

McDonald's entry into Thailand was perhaps easier than elsewhere in Asia, at least in one important respect. Given the country's rich agricultural resources and export-oriented food industry, McThai was able to identify and develop domestic suppliers for many of its inputs. Initially, the company had to import 47 different products, including pickles, beef, french fries, ketchup, and paper packaging, that amounted to about 85 percent of its input requirements. But as the size of the local operation grew, McThai was able to reduce import requirements to between 10 and 15 percent by 1999. French fries and some packaging materials are currently its main imported items.[40]

During its first two years of operation, McThai Company Limited established supply contracts with President Bakery Co. Ltd. for hamburger buns, UFM Food Centre Co. Ltd. for pies, The Borneo Company (Thailand) Ltd. for 'Kraft' brand cheese, Sri Thai Dairy Foods L.P. for various condiments, Lam Soon (Thailand) Ltd. for edible oil, Griffith Laboratories for catsup and pickles, Carnation Manufacturing (Thailand) Co. Ltd. for 'Coffee-Mate' non-dairy creamer, and the local Coca-Cola bottling company.[41]

[39] Hongladarom, Chira, *et al., op.cit.,* pages 184-187.
[40] Jitpleecheep, Sukanya and Parnsoonthorn, Krissana, "Big Macs are more than mere burgers", *Bangkok Post*, Thailand, 1 March 1999.
[41] ESCAP/UNCTC Joint Unit on Transnational Corporations, *op. cit.*, page 17.

Figure 21
McDonald's Unit Growth in Thailand



As in Taiwan, McDonald's also made an early attempt to produce its fries from locally grown potatoes. Bara Windsor and Company, a Thai trading firm that imported Idaho potato seeds, worked with some 200 hill tribe farmers to produce a crop of 1000 tons in March 1985 that was converted into fries by McDonald's. Responding to complaints that some of its fries still bear the remnants of potato skins, the company said it planned to build a new processing factory within two years in northern Thailand that would solve the problem.[42] Based on later information, however, it appears the plant was never built and that McDonald's gave up on the idea of producing its French fries locally. According to an article on its suppliers in Australia, McDonald's throughout Asia purchased 100 million kilos of potatoes in 1995, and apart from Australia and New Zealand, all countries in the region got their fries from the United States.[43] Later articles have consistently reported that this is still the case. Apparently, the conditions in Southeast Asia are not suitable for growing potatoes that meet McDonald's quality standards.

Conspicuously missing from McDonald's list of early suppliers in Thailand was a local source for its meat products, but this problem too was soon addressed. After its earlier success with MacFood Services joint venture in Malaysia, Keystone Foods LLC was eager to bring its food processing technology to Thailand, a country with greater agricultural export potential than Malaysia. In 1993, with encouragement from McThai and McDonald's Corporation, Keystone Foods formed a local joint venture, McKey Food Services (Thailand) Ltd., with GFPT Public Limited Company, a vertically-integrated

[42] Keenan, Faith, "McThai's need for potatoes takes whack at heroin", *Chicago Sun-Times*, 21 July 1985, page 23.

[43] Jermyn, Steven (Executive VP, Director of Finance, McDonald's Australia, Ltd.), "Raw material supply for McDonald's expanding South-east Asian market: Have we the capacity?", *Australian Agribusiness Review*, Volume 3, Number 2, 1995.

poultry producer and one of Thailand's biggest exporters of frozen chicken.[44] McKey Food Services soon became McDonald's exclusive supplier of meat products in Thailand, and within a few years began exporting to McDonald's operations in other countries.[45]

Having successfully established the McDonald's brand and a strong network of local suppliers in Thailand, McThai Company began to focus more on unit expansion starting in the mid 1990s. The challenges of running an increasingly complex operation while maintaining a policy of aggressive growth eventually necessitated a reorganization of McThai Company in July 1996. As part of this reorganization, Rick Helfand was named general manger of the joint venture (Dej Bulsuk remained its managing director). Helfand, who had worked for McDonald's in the United States for nearly 30 years, was given a three-year contract along with a mission to double size of the company. The western-style fast food market in Thailand, which was then valued at THB 6.5 to 7 billion (USD 260 to 280 million) annually, was expected to grow at a rate of 25 to 30 percent over the next few years, and McThai was committed to keeping up the pace. As the first foreign manager to work for McThai, Helfand considered his role to be a limited one: "My plan is to find some Thais to assume my work in the future. McThai is aimed to be a Thai-run operation."[46]

As part of its expansion strategy, McThai announced in 1997 that it was planning to add more "non-traditional" outlets in hospitals, office buildings, small shopping malls, and schools. There was already an outlet at Bumrungrad Hospital and another planned to open at St. Gabriel's College.[47] The company was also looking to add more 'up-country'

[44] Anonymous, "Chicken supplier steps up exports", *Bangkok Post*, Thailand, 14 March 2001.
[45] Anonymous, "McDonald's supplier plans export boost", *The Nation*, Bangkok, 24 September 1997.
[46] Anonymous, "Fast-food veteran to lead McThai growth", *Bangkok Post*, Thailand, 5 July 1996.
[47] Anonymous, "McDonald's looking for new locales", *Bangkok Post*, Thailand, 18 February 1997.

outlets. By April of 1997 there were 53 McDonald's outlets in Thailand, and all but four of which were in the Bangkok area (others were in popular tourist destinations: Chiang Mai, Chon Buri, Pattaya, and Phuket). One of these up-country stores, in Chiang Mai province, was a sub-franchised operation, and McThai officials said their future expansion plans included the possibility of sub-franchising in other provincial locations.[48] The company's overall goal was to reach a total of 100 outlets by the year 2000.[49] Unfortunately, other developments soon forced a revision of these plans.

A Lesson in Crisis Management

The financial crisis that hit Thailand in mid 1997 had several adverse effects on McThai's operations. Although most consider that the crisis began with the sharp devaluation of the Thai currency (Baht) in July 1997, signs of economy trouble were already evident months before then. In April 1997, with its sales slowing and costs increasing, McThai announced plans to cut some THB 40 million (then about USD 1.5 million) from its operating costs in response to a slowing economy.[50] It also launched new marketing campaigns and lowered its prices to counter the downturn in sales. When the devaluation occurred in July 1997, the effect on sales was almost immediate. McDonald's sales in mid-August 1997 dropped 10 percent from the previous month, and this was after McThai had cut its prices 35 percent for a special month-long promotion.[51] The company responded with the introduction of several lower-priced 'Happy Meal' sets later that autumn. Despite lower than expected sales and profits, the company continued

[48] Puntasen, Jim, "McThai to cut Bt 40 M in fat from budget", *The Nation*, Bangkok, 8 March 1997.
[49] Jitpleecheep, Sukanya, "McDonald's aims for 100 Thai outlets", *Bangkok Post*, Thailand, 13 March 1997.
[50] Puntasen, Jim, "McThai to cut Bt 40 M in fat from budget", *The Nation*, Bangkok, 8 March 1997.
[51] Jariyasombat, Peerawat and Jitpleecheep, Sukanya, "Thai noodles challenge the US Big Mac; Chains slash prices to attract the budget conscious customer", *Bangkok Post*, Thailand, 13 August 1997.

with plans to expand its operation and completed 1997 with 61 outlets, up from 52 in the previous year.[52]

By early 1998 it seemed clear that recovery from the economic crisis would take at least one more year. The fast food market in Thailand was expected to grow only two percent in 1998, compared to 15 percent in 1997 and as much as 30 to 40 percent in the boom years.[53] Devaluation also resulted in sharply higher costs for imported materials and supplies. Although McThai had significantly increased its domestic supplier base over the years, it still imported 10 to 15 percent of its requirements from abroad.[54] To help ease the situation, McDonald's Corporation allowed McThai and some of its other affiliates in countries hard hit by the crisis to defer their regular payment of license fees (royalties) to ease their liquidity problems.[55] As a joint venture, McThai Company did not pay a master franchise fee to McDonald's Corporation, but it does have to pay a one-time franchise or license fee when each new outlet is opened, plus a quarterly royalty fee that is reportedly equivalent to five percent of its total sales.[56]

McDonald's Corporation also helped by negotiating with other overseas operators to purchase more of their raw materials from suppliers in Thailand.[57] As McThai officials explained, by increasing business for its local suppliers, the company would reduce its own costs (through economies of scale) and ensure its survival in the local market. While this was obviously true, devaluation of the Thai Baht had also suddenly made importing

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[52] Treerapongpichit, Busrin; Petsiri, Ekarin; Intarakomalyasut, Nondhanada; and Kositchotethana, Boonsong, "Lean times on the menu for fast food", *Bangkok Post*, Bangkok, 3 November 1997.
[53] Jitpleecheep, Sukanya, "McDonald's waives fees to help Asian franchises; Thai supplier boosts sales in region", *Bangkok Post*, Thailand, 27 March 1998.
[54] Srihanam, Nitsara, "McDonald's suspends expansion plans in Asia", *The Nation*, Bangkok, 27 March 1998.
[55] *Ibid.*
[56] ESCAP/UNCTC Joint Unit on Transnational Corporations, *op. cit.*, page 20.
[57] Jitpleecheep, Sukanya, "McDonald's waives fees to help Asian franchises; Thai supplier boosts sales in region", *Bangkok Post*, Thailand, 27 March 1998.

supplies from Thailand a cheaper option for McDonald's operators in other countries. During the month of September 1997, McKey Food Services delivered THB 15 million worth of fried chicken to Hong Kong. That same month, it was announced McDonald's Singapore would shift all of its chicken purchases from the United States to Thailand starting in the fourth-quarter of 1997. The deal was expected to be worth some THB 360 million to McKey Food Services in 1998.[58]

Ultimately, these developments had an important public relations benefit for McThai. When the Thai government launched its 'buy-Thai-eat-Thai' campaign in 1998, causing some consumers to avoid foreign fast-food chains, McDonald's responded with its own advertising campaign that promoted McDonald's restaurants as 'patriotic'. Soon ads appeared on the tray liners in its restaurants with copy explaining that McDonald's is a net exporter from Thailand (through its suppliers, although this was not clearly stated in the ads).[59]

Local news reports often ignore any distinction between McThai and its suppliers, a confusion the company seems to encourage. For example, it was McThai Company officials who, in October 1998, first announced a three-year deal worth THB 1.3 billion in which McDonald's Singapore would buy additional chicken products from McKey Food Services (Thailand) Limited. Further, McDonald's Corporation was reported to be negotiating with its European operators to purchase more supplies from Thailand, and Dej Bulsuk himself was reported to have visited McDonald's operators in several other

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[58] Anonymous, "McDonald's supplier plans export boost", *The Nation*, Bangkok, 24 September 1997.
[59] Anonymous, "McDonald's proclaims itself a Thai patriot", *Wall Street Journal*, Eastern Edition, 10 August 1998, page B6.

countries to lobby them on behalf of local Thai suppliers.[60] Among the items exported from Thailand to McDonald's in other countries are various chicken products, sauces, condiments, furniture, packaging materials, and a number of promotional items, including plastic and soft toys and statues of Ronald McDonald.[61] In 1999, McThai invited McDonald's operators from Australia, China, Hong Kong, Malaysia, Taiwan, and the Philippines to visit its vegetable suppliers in Chiang Mai, who were already exporting to McDonald's in the United States. That same year, another McThai supplier exported THB 300 million worth of shrimp to McDonalds in the United Kingdom and Germany.[62]

Ironically, the financial crisis that hit Thailand has been something of a blessing to McDonald's. Although it resulted in slower market growth and reduced margins for the fast food industry, it also brought benefits – mainly in the form of increased exports – to McDonald's local suppliers and further strengthened their spirit of cooperation and partnership. It was therefore not a surprise that McKey Food Services (Thailand) Ltd. was willing to invest another THB 200 million in 1999 on technology and equipment to manufacture 'McCrispy' fried chicken locally.[63] Its gamble was offset by the fact McKey Food Services was by then exporting chicken products to McDonald's operations in South Korea and Japan, as well as Hong Kong and Singapore.[64] McKey was expecting its exports to top THB 1 billion in 2001, up considerably from THB 700 million in 2000, when 70 percent of its production (about 12,000 tons) went to export markets (55 percent

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[60] Pongvuthitham, Achara and Rungfapaisarn, Kwanchai, "McThai hopes to export to Europe", *The Nation*, Bangkok, 29 October 1998.
[61] Intarakomalyasut, Nondhanada, "Popularity of movie dolls ensure return", *Bangkok Post*, Thailand, 27 January 1999.
[62] Anonymous, "Big Mac franchisee to increase exports", *Bangkok Post*, Thailand, 16 December 1999.
[63] Jitpleecheep, Sukanya, "Fried chicken goes on the menu at restaurant chain", *Bangkok Post*, Thailand, 28 Janaury 2000.
[64] Anonymous, "Chicken wings head for South Korea: McKey's expands export contracts", *Bangkok Post*, Bangkok, 02 August 2000.

to Singapore, 13 percent to Japan, and 2 percent to Hong Kong (the balance supplied the local McThai operations). With current capacity of 16,500 tons, McKey Food Services is planning on even more export growth, which McDonald's is almost sure to demand.[65]

Loyalty and cooperation has other benefits as well. One reason for McDonald's success in Thailand has been the company's willingness to introduce new menu items tailored to the local market. Working with McKey Food Services , Sri Thai Dairy Foods, and other local suppliers, McThai developed several new products to suit Thai tastes, such as the 'McKrapraw' Burger (basil pork), 'McPanaeng Gai' Burger (chicken), and 'McSamuri' Pork Burger. In 1999, the 'McKrapraw Gai' Burger, re-named 'Amazing Thai Burger', was introduced in Singapore and tested in other regional markets.[66]

Another new product, 'McCrispy' fried chicken, was introduced in 1993 and it became successful without any special promotion. By the end of 1999 chicken products represented 30 percent of McThai's total sales.[67] Sales of chicken (and especially fried chicken) had been growing in Thailand by as much as 30 percent annually. Facing a 'chicken war' in the fast-food industry, McThai decided for the first time in January 2000 to spend more money promoting chicken products rather than burgers. It announced plans to spend THB 50 million (more than USD 1 million) in a year-long campaign to promote McCrispy, saying that it expected chicken products to increase from 30 to 40 percent of total sales.[68] [69] As 2001 began the company reported that its beef-based products, although not declining in sales, now contribute only 10 percent to McDonald's local turnover, while its chicken products contribute almost 70 percent. To capitalize on

[65] Anonymous, "Chicken supplier steps up exports", *Bangkok Post*, Thailand, 14 March 2001.
[66] Kwanchai Rungfapaisarn, "Amazing feat for local burger at Macs", *The Nation*, 16 December 1999.
[67] Choosak Jirasakunthai, "McDonald's joins the chicken war", *The Nation*, Bangkok, 28 January 2000.
[68] Jirasakunthai, Choosak, "McDonald's joins the chicken war", *The Nation*, Bangkok, 28 January 2000.
[69] Choosak Jirasakunthai, "Ex-soldier in chicken, pizza battles", *The Nation*, Bangkok, 22 February 2000.

this success, McThai introduced another new product, a Pepper Chicken Burger.[70] This growth in the popularity of McDonald's chicken products in 2000 reflects a basic consumer preference in Thailand, along with increased competition (greater promotion and lower prices) within the chicken sector of the local fast-food market. Public concerns about allegations of possible BSE (mad cow disease) contamination of imported beef also contributed to a relative decline in beef sales during 2000, although McDonald's was quick to point out that all of the beef it uses in Thailand comes from local sources.

The most obvious adverse impact of the financial crisis was on McThai's unit growth. Throughout Asia McDonald's Corporation cut back on planned expansions for 1998, and in March 1998 McThai announced that it had cut its own expansion plans for the year from 10 to 6 new outlets, all of which were to be located in Bangkok. Upcountry expansion plans were put on hold indefinitely, as the company believed the provincial market had temporarily lost its potential.[71] As it turned out, just 3 new outlets were added in 1998, making a total of 64 outlets in operation at the end of that year. (One of the new outlets was the company's first stand-alone, drive-through restaurant, located at an Esso petrol station on the Bangna-Trad highway linking Bangkok with Chonburi, Pattaya, and Rayong on Thailand's eastern seaboard, and area of considerable industrial development in the 1990s.[72]) This slowdown in McDonald's expansion plans proved only temporary, however, as the company appeared to see an opportunity in the financial crisis.

Through aggressive advertising, promotions, and price cuts, McThai's revenues in 1998 were 10 percent higher than in 1997 (greatly exceeding the company projection of

[70] Jitpleecheep, Sukanya, "McDonald's to open 15 new Thai outlets", *Bangkok Post*, Thailand, 30 January 2001.
[71] Srihanam, Nitsara, "McDonald's suspends expansion plans in Asia", *The Nation*, Bangkok, 27 March 1998.
[72] Anonymous, "A tank of gas with fries please", *Bangkok Post*, Thailand, 22 September 1998.

just 2 percent growth for the entire fast food market). On this news, McThai projected it would grow by 10 to 15 percent during 1999.[73] As it turned out, year-on-year sales the first seven months of 1999 increased 26 percent, and expansion plans were once again underway.[74] McThai opened 10 new outlets in 1999, giving it a total of 74 outlets at year's end, and claimed an 82 percent share of the local burger market.[75] In December 1999, McThai announced plans to open 15 new outlets in 2000, including two drive-through outlets and four up-country outlets in Hat Yai, Samui, Nakhon Ratchasima, and Phuket; its long-term plans called for a total of 200 outlets in Thailand by 2004.[76] In August 2000 the company announced plans to invest another USD 12.5 million to increase the number of outlets, saying it would open 20 more stores in 2001, five of which would be in up-country locations.[77]

Poised for the Future

Continuing to expand during the crisis appears to have given McDonald's some advantages going forward, but it also precipitated a change in ownership of the local operating company. Responding to an article that appeared in August 2000, Dej Bulsuk denied that he had sold his entire interest in McThai to his foreign partner, McDonald's Corporation, along with claims he made a handsome profit in the exchange. However, he did admit that his controlling stake in the company had been reduced to less than 51

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[73] Srimalee, Somluck and Rungfapaisarn, Kwanchai, "McDonald's, KFC upbeat on sales", *The Nation*, Bangkok, 16 March 1999.
[74] Srimalee, Somluck and Rungfapaisarn, Kwanchai, "Fast-food chains to expand outlets", *The Nation*, Bangkok, 4 September 1999.
[75] Rungfapaisarn, Kwanchai, "Amazing feat for local burger at Macs", *The Nation*, Bangkok, 16 December 1999.
[76] *Ibid.*
[77] Anonymous, "More McDonald's ready to mushroom", *Bangkok Post*, Bangkok, 11 August 2000.

percent during the crisis period, saying this had happened three years earlier.[78] In fact, it occurred sometime during 1998. The McDonald's Corporation annual report for that year noted an increase in the company's ownership in Thailand (and also in South Korea and the Philippines) that resulted in its conversion from an affiliate to majority-owned subsidiary for financial reporting purposes.

Details on the new ownership structure of McThai Company Limited were not revealed by McDonald's (or by Dej Bulsuk), nor is it not clear this change in ownership involved the sale of any existing shares. Given the timing, it seems more likely that continuing to expand the chain during the crisis years (1997 to 1999) required additional capital investments that only McDonald's Corporation could afford, thus resulting in the dilution of Dej Bulsuk's stake in the company. It was obviously in neither party's interest to announce a dilution of local ownership, especially at a time of heightened nationalist sensitivities, with foreigners perceived to be rushing to acquire distressed assets in Thailand, but when the news finally broke there was no false denial (as it seems was the case in the Philippines). However, the company was quick to point out that Dej Bulsuk was still president of McThai Company Ltd., noting that Mike Gomes had already been the managing director for over a year (since August 1999). Gomes, who had previously worked for McDonald's in the United Kingdom, apparently replaced Rick Helfand upon the conclusion of his three-year contract.[79]

As for the local company's performance, McThai's year 2000 results were a bit disappointing, at least by McDonald's standards. As a result of increased competition and a continuing weak economy, McThai's average sales per outlet grew by 7 percent in

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[78] Anonymous, "Dej denies McThai sale: Has not sold stake to US McDonalds", *Bangkok Post*, Bangkok, 07 August 2000.
[79] *Ibid.*

2000, compared to 20 percent growth in 1999. However, according to company officials, the total fast food market in Thailand actually shrank by 20 percent in 2000, down to THB 10 billion (about USD 260 million) from nearly THB 12.5 billion in the previous year. Considering these circumstances, McThai had actually improved its position in the market. McDonald's finished the year 2000 with a total of 86 outlets in Thailand. This was three fewer stores than had been targeted, but with plans to open another 15 outlets during 2001, the company had hardly given up on unit expansion.[80]

It says something about a company when 7 percent annual sales growth during a major economic slowdown, is considered disappointing. McThai was obviously not satisfied with its position in the market, or the fact that it had experienced zero growth in fourth-quarter of 2000. With difficult economic times expected to continue, the company launched a new price campaign, offering burgers for just THB 19, which resulted in 20 percent jump in sales in first quarter 2001 (over the previous quarter). As a result of the campaign, McThai was expecting the number of customer transactions to increase 20-25 percent.[81] A similar optimism is behind the firm's announcement in May 2001 that it is planning to add 21 new outlets in 2001, an increase from the 15 outlets that had earlier been announced.[82]

In a related move, McThai announced in July 2001 that it would begin offering new franchises. Under the plan, local individuals will have the opportunity to take either 100 percent or 30 percent stake in a McDonald's restaurant. Understandably, McThai had abandoned its franchising plans when the financial crisis hit Thailand in 1997, but

[80] Jitpleecheep, Sukanya, "McDonald's to open 15 new Thai outlets", *Bangkok Post*, Thailand, 30 January 2001.
[81] Rungfapaisarn, Kwanchai, "McDonald's aims at little guys", *The Nation*, Thailand, 18 April 2001.
[82] Rungfapaisarn, Kwanchai, "Nothing fast about burgers", *The Nation*, Thailand, 10 May 2001.

now the company said it plans to "convert 50 percent of upcountry stores to franchises in next three years." No franchises would be offered in Bangkok; all of the new franchises would be in upcountry (provincial) locations where there are now 15 McDonald's stores. Taking advantage of local knowledge in managing these upcountry stores was specifically mentioned as the reason for McThai's renewed interest in franchising, although it was also noted that franchising would reduce company expenditures by 15 to 20 percent. Two types of franchise deals were on offer: conventional franchises with 100 percent ownership and joint ventures in which McThai holds 70 percent of the equity. Applicant screening was expected to take about one year, with an initial interview period lasting about two months, followed by a nine-month training program to be capped off by three days of on-the-job training. The required investment budget for franchisees was given as between THB 12 million and THB 15 million (USD 270,000 to USD 330,000), down considerably from the earlier stated THB 20 million. Dej Bulsuk also added, "We will be more relaxed and flexible in negotiating with individual investors who are interested in becoming franchisees". The last franchised store in Thailand had opened six years earlier (1995) in Chiang Mai, and it remained one of only two franchised McDonald's stores in the country (both of which were operated by same individual in Chiang Mai).[83]

It seemed the timing was right to re-launch the franchising program in Thailand. In the first half of 2001 McDonald's sales were up 20 percent (as compared to its target growth of 12 percent). Perhaps believing the firm had discovered the right combination of price and products to continue steady growth in Thailand despite a difficult economy, Dej Bulsuk announced in July 2001 McThai aimed to have 200 stores – more than double

[83] Rungfapaisarn, Kwanchai, ""McDonald's franchises on offer", *The Nation*, Thailand, 11 July 2001.

the current number – within seven years.[84] (The company finished 2001 with a total of 98 outlets in Thailand.) With another eight years to go under the original 25-year license agreement, McThai Company Limited may well reach that goal before the time comes for McDonald's to decide whether or not to exercise its option to buy out its local partner.

At least for now, Dej Bulsuk seems content with his role as president of the company. With day-to-day operations being handled by a managing director, he finally has a bit more time to pursue his real passion: composing music. Dej's first CD, 'River of Kings' was recorded by Shardad Rohani and the Bangkok Symphony Orchestra in early 2000, and was immediately made available for sale at leading music stores and McDonald's branches nationwide, with the proceeds going to charity.[85]

[84] Rungfapaisarn, Kwanchai, ""McDonald's franchises on offer", *The Nation*, Thailand, 11 July 2001.
[85] Anonymous, "Newsmakers: McMusical surprise", *Bangkok Post*, Thailand, 15 February 2000.

SOUTH KOREA

A Slow Start

McDonald's did not enter the South Korean market until 1988, by which time the local fast food industry was already rapidly developing. Hamburger-related fast food sales in 1987 totaled USD 87.5 million, which represented an increase of 30 percent over the previous year. Wendy's already had 11 outlets in the country and Burger King six.[1] Several local burger chains were also in the mix, including the current market leader Lotteria, which started in 1979.[2] So what took McDonald's so long?

According to one source, McDonald's Corporation had commissioned a market survey in the 1970s to investigate the prospects for entering Korea, but to the company's disappointment the survey results showed that many Koreans were strongly anti-American.[3] Such a finding may have delayed McDonald's decision to enter the market, but it was not for long. By the early 1980s, efforts were underway to identify a suitable local partner and to secure government approval to launch the business. However, both were proved to be difficult tasks.

McDonald's eventually settled on Ahn Hyo Young as its first choice for a local partner in South Korea. According to Ahn, a Harvard-trained accountant, McDonald

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[1] Manguno, Joseph P., "McDonald's outlet in Korea to target new middle class", *The Wall Street Journal*, 12 April 1988.

[2] Lotteria Company Limited is part of the Lotte Group, which also runs a chain of Lotte Department Stores in Korea. A fast-food company specializing in western-style hamburgers, Lotteria was originally started in Japan, but owing to the ethnic background of its Korean founder, the chain received government approval to enter the South Korea market long before other 'foreign' fast-food companies. Sources: Bak, Sangmee, "McDonald's in Seoul: Food Choices, Identity, and Nationalism", Chapter 4 in *Golden Arches East: McDonald's in East Asia*, edited by James L. Watson, Stanford University Press, 1997, page 139. See also: Anonymous, "Lotteria to launch pizza chain shortly", *Korea Economic Daily*, 28 November 1995.

[2] Manguno, Joseph P., "McDonald's outlet in Korea to target new middle class", *The Wall Street Journal*, 12 April 1988.

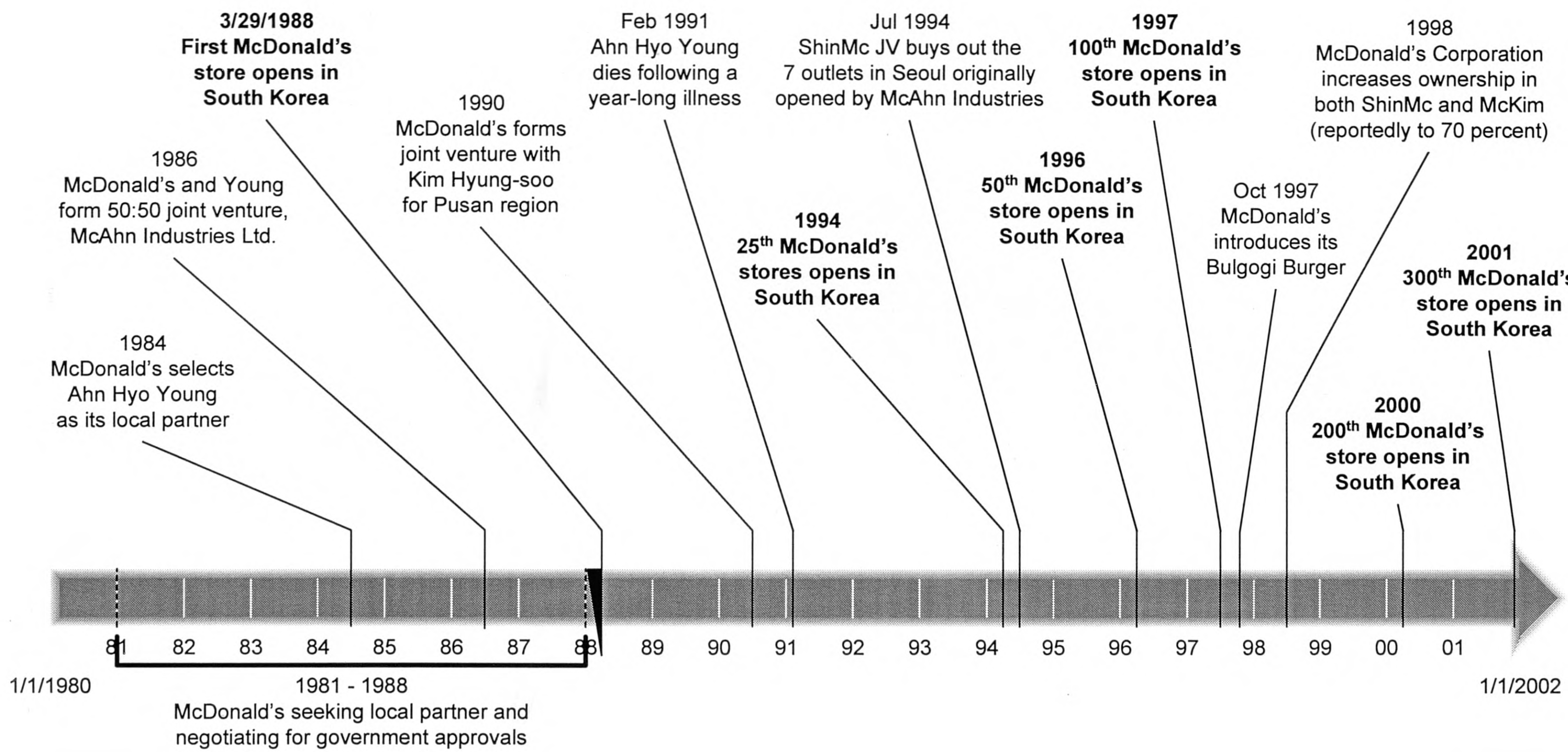
[3] Bak, Sangmee, "McDonald's in Seoul: Food Choices, Identity, and Nationalism", Chapter 4 in *Golden Arches East: McDonald's in East Asia*, edited by James L. Watson, Stanford University Press, 1997, page 139.

talked to 16 potential partners before finally selecting him in 1984. Another two years then passed before McDonald's and Ahn each put up USD 1 million in capital to form McAhn Industries Limited, a 50:50 joint venture, to run the McDonald's business in Seoul. This delay was apparently the result of a long struggle to obtain government approval of McAhn's royalty payments to McDonald's, as well as tight import restrictions on food products. Once the royalty issue was resolved, the challenge became to find local suppliers of high-quality beef and potatoes at a reasonable price. Even McDonald's famous golden arches ran into government approval problems, as the City of Seoul regulates the size and color of signs. In a way only a local partner could, Ahn said of the signs, "It may be against the law, but we're putting them up anyway." Finally, after seven years of preparation, McDonald's was ready to open its first store.[4]

The first McDonald's in South Korea opened on 29 March 1988. It was located in Apkuchong-dong, one of the most exclusive districts in Seoul and an area known for its cafes and boutiques that are frequented by affluent, trendy members of the younger generation.[5] The company's initial plans were to expand slowly. As Ahn said in April 1988, "We are starting small. We're hoping to open three outlets this year and five next year. After that, we'd like to open five every year."[6] As it turned out, expansion was even slower than that. Two years after the first McDonald's store opened, there were just three outlets in the country, and by the end of December 1990, there were only four McDonald's restaurants in South Korea.

[4] Manguno, Joseph P., "McDonald's outlet in Korea to target new middle class", *The Wall Street Journal*, 12 April 1988.
[5] Bak, Sangmee, *op. cit.*, page 139.
[6] Manguno, Joseph P., "McDonald's outlet in Korea to target new middle xlass", *The Wall Street Journal*, 12 April 1988.

Figure 22
McDonald's in Korea Timeline



One of the problems was apparently McDonald's insistence on a policy of either owning its store sites or obtaining them under a long-term lease. Land prices in Seoul were high at the time, with heavy-traffic sites costing about USD 7 million to buy or requiring a deposit of USD 1 million to rent. Considering this, some observers believed that McAhn Industries was simply under-capitalized, and balked at the price of Korean real estate. Others cited a different problem: with real-estate prices and rents rising more than 50 percent a year, speculators were reluctant to sell or even lease long term. Further exacerbating matters was the high price of raw materials. As a result of import restrictions and tariffs, McDonald's reportedly faced higher prices for raw materials in Korea than elsewhere in Asia.[7]

By early 1991, it appeared that McAhn Industries had finally adapted to the local real estate situation and was gearing up for more rapid expansion, as it announced plans to have 30 restaurants in Korea by the end of 1993.[8] However, it was about this same time that another explanation for McDonald's slow start became apparent.

Ahn Hyo Young, McDonald's local partner in Korea, died in early February 1991. He had been seriously ill for about a year, and uncertainty about his condition no doubt contributed to McDonald's troubles in expanding the chain. Understandably, it would have been difficult to make long-term decisions in such circumstances, and a few weeks after Ahn's death, a company spokesman in the United States said only that McDonald's remained uncertain what to do about a local partner.[9]

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[7] Darlin, Damon, "South Koreans crave American fast food", *Wall Street Journal*, Eastern Edition, 22 February 1991.
[8] *Ibid.*
[9] *Ibid.*

New Partners

A total of seven McDonald's restaurants were opened in Seoul by McAhn Industries, and these continued to operate after Ahn's death. McDonald's began looking for someone else to develop the chain in Seoul, and eventually selected Shin On-shik (also known as Steve Shin), as its new partner. Together they formed a 50:50 joint venture company called ShinMc Limited, and named Shin as its president.[10] [11] In July 1994, ShinMc bought out the seven McDonald's outlets that had originally been opened by McAhn Industries.[12]

Meanwhile, a different partner had been found to develop the McDonald's chain in Pusan, South Korea's second-largest city which is located at the opposite end of the peninsula from the Seoul-Inchon area. Kim Hyung-soo, or H.S. Kim, was born in Pusan in 1959. Kim apparently had little previous work experience, but was well-trained in business, having received an undergraduate degree in the subject from American University in Washington, D.C. in 1986, followed by an MBA from Korea University in 1989. In 1990 McDonald's and Kim formed a 50:50 joint venture company called McKim Limited, with Kim serving as president.[13] (One source suggests a later date for the founding of McKim, saying that it was established after ShinMc, which itself was obviously not formed until after Ahn's death in early 1991.[14])

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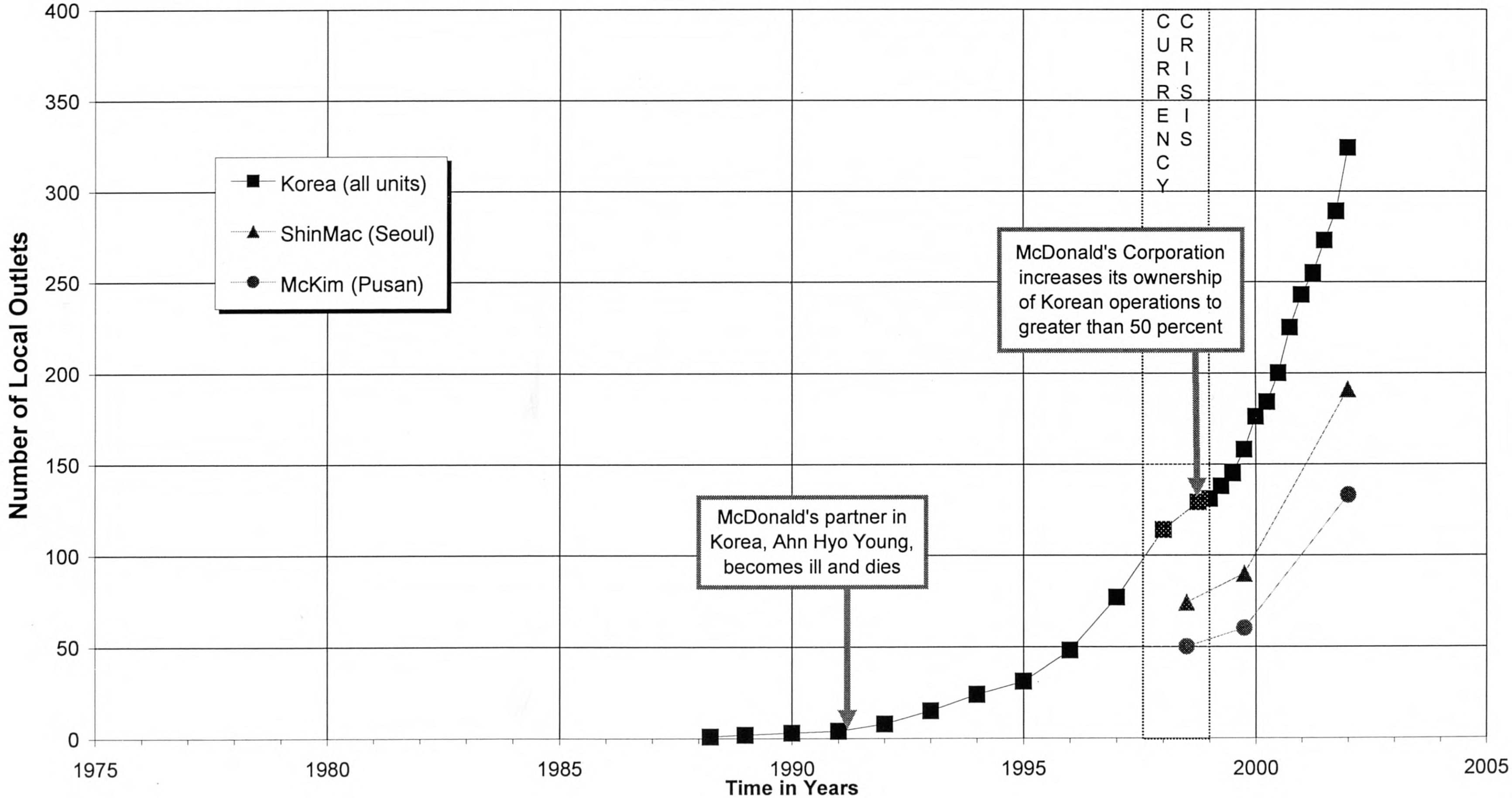
[10] Frumkin, Paul, "South Korea regains economic bite, allure for U.S. brands", *Nation's Restaurant News*, New York, Volume 33, Issue 39, 27 September 1999.
[11] Anonymous, "Franchises Sought by McDonald Korea to improve business", *Korea Economic Daily*, South Korea, 15 June 1998.
[12] Bak, Sangmee, *op. cit.*, page 140.
[13] Anonymous, "McDonald's 'glocalization' drive appealing to Koreans", *The Korea Times*, 16 January 2002.
[14] Bak, Sangmee, *op. cit.*, page 140.

It is not known whether McDonald's had originally planned to establish two separate operating companies in South Korea – one for the Seoul-Inchon region in the northwest and the other for the Pusan region in the southeast – but such a decision is not unreasonable considering the geography and population distribution in the country. Each region was populous enough to support a large chain of restaurants in its own right, and having separate partners for each area would allow McDonald's to customize its operations based on local knowledge and experience in the two markets. Diversity also creates more opportunities for innovative problem-solving, with the potential for one partner to develop new ideas that may prove helpful to the other. The two operations could also benchmark one another in terms of their performance; in a sense, their pride alone would pit the local partners in a friendly competition to see which made the most of his respective region. Finally, such an arrangement would give McDonald's additional flexibility to deal with a weak or recalcitrant partner – or in the worst case, a partner's untimely demise – as there would always be one experienced local partner who could take over (through a buyout) the operations of the other. The main difficulties would involve the coordination of policies and decisions that affect both joint ventures, such as making volume-purchasing commitments to local suppliers. However, with McDonald's Corporation being a 50:50 partner in each joint venture, this should not be much more difficult than decision-making in a single equal partnership (and probably easier than dealing with either regional cooperatives or individual franchisees, as the company does in the United States). In any event, having two local partners in Korea seemed to work.

Figure 23
McDonald's Unit Growth in South Korea



By the end of 1994, almost seven years after McDonald's began operating in South Korea, there were still just 31 outlets in the country. As shown in Figure 23, that number more than doubled to 77 outlets within two years, and by the end of December 1997 there were 114 McDonald's restaurants operating throughout the country. Both partnerships developed at a similar rate. In June 1998 it was reported that there were 124 McDonald's outlets in South Korea, 74 of which were in the Seoul region.[15] A little over two years later, in September 1999, ShinMc reportedly had about 90 outlets operating in the Seoul region, compared with about 60 outlets belonging to McKim in the Pusan region.[16] And out of a total of 324 restaurants in South Korea at the end of December 2002, there were 191 in the ShinMc region and 133 in the McKim region.[17] Moreover, nearly all of these were company-owned and company-operated stores.

An article appeared in June 1998 which reported that McDonald's was seeking additional franchisees in Korea as a means of expanding its business. It quoted Shin On-shik (president of ShinMc Limited) as saying, "By utilizing various means of recruitment available to us, we have set out to recruit franchisees in earnest." At the time, McDonald's had seven franchised outlets out of 124 total outlets in the country. Six of the franchised stores were in the ShinMc region.[18] Although the timing of this initiative seems a bit dubious, coming as it did amidst an economic crisis that followed the currency devaluations in late 1997, some new franchisees were signed up. In January 2002, a local newspaper article quoted Kim Hyung-soo (identified as the president of

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[15] Anonymous, "Franchises sought by McDonald Korea to improve business", *Korea Economic Daily*, South Korea, 15 June 1998.
[16] Frumkin, Paul, "South Korea regains economic bite, allure for U.S. brands", *Nation's Restaurant News*, New York, Volume 33, Issue 39, 27 September 1999.
[17] Email correspondence received from "Jin Gyu Shin" at <jgshin@mcdkorea.co.kr> in response to questions on the current status of ShinMc's operations and franchising program, 13 February 2002.
[18] Anonymous, "Franchises sought by McDonald Korea to improve business", *Korea Economic Daily*, South Korea, 15 June 1998.

McDonald's Korea) who said, "McDonald's Korea's main office controls the operation of 309 of the 321 branches to maintain food service and quality, with the remaining stores being run by independent businessmen and women, our franchisees."[19] This suggests 12 franchised outlets at the end of 2001 (McDonald's Corporation officially reported a year-end total of 324, rather than 321, outlets in South Korea).

Asked to provide additional information on McDonald's franchising program, a ShinMc representative replied that there were 12 individual franchisees operating a total of 18 franchised outlets. It is not clear whether this accounts for all franchisees in the country, or only those in the ShinMc region (the locations the franchised stores were given as Seoul, Kangwon, Kyunggi and Choongchung, all of which are in the northern part of the country).[20] Six of the 18 franchised outlets were identified as 'conventional licensed stores', with the other 12 being 'developmental licensed stores'. The former was described as a four-item investment consisting of equipment, sign seating and décor, while the latter includes these items plus lease hold improvements and rental costs.[21] (While the exact distinction between them is not entirely clear, it may be that these 12 'developmental licensed stores' are the same as the 12 franchised stores to which Kim Hyung-soo earlier referred.) What is clear from this is that franchising has been a significant factor in McDonald's growth in South Korea.

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[19] Anonymous, "McDonald's 'glocalization' drive appealing to Koreans", *The Korea Times*, 16 January 2002.
[20] Email correspondence received from "Jin Gyu Shin" at <jgshin@mcdkorea.co.kr> in response to questions on the current status of ShinMc's operations and franchising program, 13 February 2002.
[21] Email correspondence (second in a series) received from "Jin Gyu Shin" at <jgshin@mcdkorea.co.kr> in response to questions on the current status of ShinMc's operations and franchising program, 18 February 2002.

Crisis and Competition

Beginning in late October 1997, the South Korean Won underwent a severe devaluation brought on as a contagion effect of the Southeast Asian currency crisis. By mid December it had lost more than 45 percent of its value against the US Dollar (dropping from about KRW 900 to more than KRW 1600 per USD). The currency remained extremely volatile for the next several months, and then slowly began to recover. Toward the end of 1998 its value finally stabilized around KRW 1200 per USD, down 25 percent from fifteen months before. By then of course, the damage had already been done, as it precipitated a financial crisis that further contributed to an economic downturn. This changed the competitive landscape in the fast food industry.

As elsewhere in Asia, McDonald's saw an opportunity in the financial crisis. Currency devaluation and distressed properties made investing in expansion a cheaper proposition than before – at least for the American company. Unfortunately, McDonald's local partners were not immune to the crisis effects. Moreover, since it began operations in 1988, the McDonald's chain in Korea had suffered losses in every year except for 1995.[22] This made it even more difficult for the local partners, who themselves had no exchange-rate advantage, to take advantage of the crisis conditions – they were struggling just to pay their bills. In June 1998 it was reported that McDonald's Korea (presumably in reference to both local joint ventures) had plans "to obtain support from its American headquarters by introducing a preferential bank loan, deferring interest payment for a set period of time. According to Shin [On-shik], the loan will be used for settling short-term

[22] Anonymous, "Franchises sought by McDonald Korea to improve business", *Korea Economic Daily*, South Korea, 15 June 1998.

liabilities."[23] As further evidence of a cash crunch, McDonald's had opened 15 outlets in South Korea during the first half of 1998 (most of which were probably underway before the crisis hit), but only two new stores debuted there in the second half of that year. Not surprisingly, considering what we now know happened elsewhere in the region, McDonald's Corporation increased its ownership in South Korea during 1998, converting its operations there from affiliates into majority-owned subsidiaries.[24] McDonald's itself provided no other details about its two local partnerships in Korea, but a *Wall Street Journal* article that appeared in late November 1998 suggests they received equal treatment, saying that McDonald's "directly owns 70 % of its two franchisees there."[25]

With an influx of new capital from the parent company, McDonald's Korean operations were able to accelerate their expansion plans in an attempt to gain ground against their principal market rival, Lotteria. By 1993 the number of McDonald's outlets in South Korea had already surpassed those of both Burger King and Wendy's, and by November 1998 the world's leading burger chains had in the country a total of 130, 49 and 15 outlets, respectively. However, the gains McDonald's made against its traditional competitors were not attributable to the financial crisis. For the second time in five years, the master franchise for Burger King in Korea changed hands in February 1998 (too early to blame it on the financial crisis).[26] [27] Then in November 1998, after a long-standing dispute with its master franchisee that was only made more bitter as a result of problems

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[23] Anonymous, "Franchises sought by McDonald Korea to improve business", *Korea Economic Daily*, South Korea, 15 June 1998.
[24] McDonald's Corporation 1998 Annual Report.
[25] Schuman, Michael and Gibson, Richard, "Following Wendy's exit, Koreans munch on Winner's", *Wall Street Journal*, Eastern Edition, 27 November 1998, page B1.
[26] Anonymous, "Burger King Korea yields high quality with fast growth", *Korea Economic Daily*, 19 November 1996.
[27] Anonymous, "Burger King, Polo transferred from Ilkyung to Doosan Group", *Korea Economic Daily*, South Korea, 9 February 1998.

related to the crisis, Wendy's finally gave up on the Korean market. Its local partner immediately converted all 15 of his outlets to a new local brand he called 'Winners'.[28] As a result of these difficulties, neither Burger King nor Wendy's proved to be much of threat to McDonald's market position after 1998 (although Burger King did manage grow to 88 outlets by October 2000). Over the next three years, McDonald's expanded its chain in South Korea at an average annual rate exceeding 35 percent, to a total of 324 outlets at the end of 2001 (compared to 131 outlets at the end of 1998). However, local market leader Lotteria was also expanding in the wake of the crisis, and grew its chain from 424 outlets in June 1999 to 560 outlets by October 2000.[29][30]

Increasing its physical presence in the market was only one part of McDonald's growth strategy. In October 1997,just as the currency crisis was beginning, McDonald's introduced its first new product specifically developed for the Korean market: the Bulgogi Burger. The firm advertised heavily to promote its new product, which was aimed directly at the market leader, Lotteria, which five years earlier had introduced its own bulgogi sandwich. Lotteria responded with its own campaign emphasizing that its signature burger contained beef rather than pork.[31] (In September 1999 a McDonald's spokesman was quoted as saying his firm's bulgogi item was nothing more than its traditional breakfast sausage patty garnished with lettuce and a seasoned sauce.[32]) Nevertheless, the Bulgogi Burger was a success.

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[28] Schuman, Michael and Gibson, Richard, "Following Wendy's exit, Koreans munch on Winner's", *Wall Street Journal*, Eastern Edition, 27 November 1998, page B1.
[29] Anonymous, "Competition cooking in fast-food industry", *The Korea Economic Weekly*, 8 July 1999.
[30] Anonymous, "Stiffer competition felt in fast-food retail market", *Korea Economic Weekly*, South Korea, 2 October 2000.
[31] Anonymous, "Hamburger competition heats up", *Korea Times*, South Korea, 19 October 1998.
[32] Frumkin, Paul, "South Korea regains economic bite, allure for U.S. brands", *Nation's Restaurant News*, New York, Volume 33, Issue 39, 27 September 1999.

By late 1998 the faltering economy had taken its toll on the fast food industry, and firms were scrambling to find new ways to compete. Low prices were one answer, and McDonald's joined the discounting fray with a special one-month promotion in December 1998, ostensibly to celebrate its 10th anniversary in the country. The company cut its prices on basic hamburgers and cheeseburgers by 25 percent, to KRW 750 and KRW 900 respectively (the same prices as ten years before).[33] Instead of lowering prices on their existing products, some firms responded by offering cheaper, 'kid-sized' hamburgers. Lotteria introduced its "IMF Burger" and KFC served up the KRW 1000 "New Colonel Burger". This prompted McDonald's to extend its December 1998 price cut on hamburgers into early 1999. There was also an increased effort by companies to compete at the high end of the market, against existing favorites such as Burger King's KRW 3100 "Whopper". Several firms rushed to offer larger, deluxe hamburgers, such as Lotteria's KRW 3000 "BB Burger" and McDonald's "Tukbul Burger", a mammoth sandwich with two pork patties that sold for KRW 2800.[34] A host of other promotional schemes were also tried, including coupons and prize giveaways, as firms tried to maintain their market shares.

The price war continued even as the economy began showing signs of a recovery in early 1999. In February 1999, McDonald's lowered the price of its Bulgogi Burger and McChicken sets (value meals that include a sandwich, french fries and soft drink) by 24 percent (to KRW 2400) in Pusan. Having lost its 1997 price war with McDonald's in Japan, Lotteria immediately responded with price cuts of its own, and reportedly adopted a policy to under-price McDonald's by five percent on all menu items; how long it stuck

[33] Anonymous, "McDonald's 10th year in Korea", *The Korea Times*, 4 December 1998.
[34] Anonymous, "Large and mini hamburgers dot the market", *The Korea Times*, 4 January 1999.

with this policy is not known. At the time (in early 1999), Lotteria's market share was estimated at 40 percent, compared to 19 percent for second-place McDonald's, which was determined to catch up.[35] McDonald's launched another one-month promotion in April 1999, lowering the price of its Big Mac burgers from KRW 3000 to KRW 1999.[36]

Price competition among the major fast-food firms became increasingly intense toward the end of 1999, as the lists of discounted items continued to change each month. It continued into the following year. For the month of February 2000, McDonald's sold its regularly-priced KRW 1000 french fries for KRW 500, a move the firm said resulted in a five-percent jump in sales. Encouraged by this, McDonalds extended the discount pricing to ice-cream cones, reduced the price from KRW 700 to KRW 300. Then in late March 2000, McDonald's began another one-month promotion, handing out coupons that allowed customers to buy a KRW 3000 Big Mac for just KRW 1000 if they first sang the McDonald's song (a jingle that was widely advertised on television) when placing their order. Lotteria, Burger King, KFC, Popeye's and other fast-food chains responded with similar ads and promotions in a desperate effort to retain market share.[37]

It is not clear that McDonald's had actually started the price war, but the company was certainly determined to win it. At stake was a fast-food market analysts estimated would excees KRW 1 trillion (USD 900 million) in 2000, a 25 percent increase over the previous year. Sales of the five leading firms during the first eight months of 2000 were estimated as: KRW 305 billion for Lotteria, KRW 148 billion for McDonald's, KRW 110

[35] Shim, Shang-bok, "Hamburger war getting hotter between Lotteria and McDonald's", *Joong Ang Ilbo*, 21 May 1999.
[36] Anonymous, "Business Bulletin: Big Mac to be sold at 1,999 Won", *The Korea Times*, 31 March 1999.
[37] Pyo Jae-yong, "Ketchup not the only thing running red during fast-food price wars", *Joong Ang Ilbo*, 24 March 2000.

billion for KFC, KRW 95 billion for Popeye's, and KRW 55 billion for Burger King.[38] McDonald's projected in April 2000 that its own sales for the year would exceed KRW 260 billion, a dramatic increase over its 1999 sales of KRW 170 billion. The company also announced plans to have 230 outlets in operation by the end of the year (a target it easily exceeded), along with a long term goal of 1000 outlets in Korea by the year 2009.[39]

One might expect that McDonald's local supply chain played an important role in giving the firm a competitive advantage in this price-conscious market. Unfortunately, very little information could be found (in the English language press) about McDonald's supplier network in Korea. Maeil New Zealand Cheese Company (Korea) Limited, a local joint venture of the New Zealand Dairy Board, produces cheese for McDonald's in Korea, and also exports cheese to McDonald's in Japan; however, it is not an exclusive supplier. In fact, this one company claims to supply 95 percent of the domestic fast-food hamburger market.[40] As for McDonald's meat suppliers, Keystone Foods (one of the company's major suppliers in the United States) lists Korea among the countries it serves in Asia, yet it is not clear from this whether it has any production facilities there.[41] In fact, there are several reports that McKey Food Services, a Keystone Foods affiliate in Thailand, has supplied chicken products to McDonald's in Korea since August 2000.[42] It may simply be that McDonald's Korea still imports many of its key food requirements. After all, South Korea is not a major producer or exporter of agricultural products.

[38] Anonymous, "Stiffer competition felt in fast-food retail market", *Korea Economic Weekly*, South Korea, 2 October 2000.
[39] Anonymous, "McDonald's Korea grows rapidly, turnover to hit W260 bil. this year", *The Korea Times*, 24 April 2000.
[40] Anonymous, "Maeil NZ Cheese Co. Exports Sliced Cheese to Japan", *The Korea Times*, South Korea, 29 September 1999.
[41] Keystone Foods website: <www.keystonefoods.com>.
[42] Anonymous, "Chicken Wings Head for South Korea: McKey's Expands Export Contracts", *Bangkok Post*, Bangkok, 02 August 2000.

McDonald's is also relatively new in Korea, and it is only within the last five or six years that has the chain grown large enough to support a network of exclusive local suppliers. Confirming this is a January 2002 article that said, "seventy percent of the raw materials for food production and most of the equipment McDonald's uses [in South Korea] are local products".[43] Given that 30 percent of its food supplies are imported, McDonald's may not have any significant cost advantage over its local rival, Lotteria. At least that is how things appeared when the price war began.

In November 1999, it was reported that the Korean Fair Trade Commission (FTC) had began an investigation into possible unfair trade practices by 18 leading fast food restaurants and bakery franchisers. The targeted franchisers, which reportedly included Lotteria and Popeye's, were suspected of forcing their franchisees to buy supplies only from designated companies. While such tie-ins can provide a lucrative source of funds to the franchiser, they have previously been found to be illegal in other countries. The FTC was also planning to investigate other alleged abuses by franchisers, such reneging on exclusive territory clauses or failing to make timely refunds of deposits to franchisees whose contracts had been broken.[44] McDonald's own purchasing practices, along with its local organizational structure, which included only a few independent franchisees, would probably not have subjected the company to such scrutiny. Further, any remedies that might be imposed by the FTC to correct such alleged abuses by franchisers would likely have a greater negative impact on McDonald's competitors. Therefore, McDonald's may indeed have a competitive advantage, at least in the long run. (No subsequent mention of this particular investigation by the FTC has been found, but from experience elsewhere it

[43] Anonymous, "Company Introduction", *The Korea Times*, 16 January 2002
[44] Anonymous, "18 Franchises under probe for possible unfair practices", *The Korea Herald*, South Korea, 16 November 1999.

seems reasonable to expect that similar issues of franchisee rights will come under further legal and regulatory scrutiny.)

Looking Forward

As year 2000 ended, there was nothing to suggest that price competition in the Korean fast-food market was coming to an end. In December, McDonald's launched yet another month-long promotion, this time selling its regularly-priced KRW 1000 hamburgers for half that amount.[45] Then in January 2001 the company began selling its Bulgogi Burger for just KRW 990 (which originally sold for KRW 2000). Meanwhile other companies offered their own discounts and promotions. Lotteria cut the price of its french fries by 33 percent, and sold its chicken burger at a 15 percent discount, as part of its celebration for the opening of its 600th store.[46]

McDonald's also continued to expand, opening its 300th store, a drive-through unit located in Inchon (in the Seoul region), on 19 November 2001.[47] In January 2002, the company projected that its sales for the year would reach KRW 380 billion, a dramatic increase over its sales of KRW 260 billion (about USD 200 million) in 2001. It also announced plans to open another 100 stores in 2002, which by the end of the year would give it well over 400 outlets.[48]

Whether McDonald's was yet making a profit in Korea is not known. However, there is no question that it was making its presence felt, and changing the food service industry in the process. One way it did so was through its non-traditional hiring practices

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[45] Anonymous, "McDonald's offering discount rate", *The Korea Times*, 13 December 2000.
[46] Choi Joon-Ho, "New fast-food price war", *Joong Ang Ilbo*, South Korea, 26 January 2001
[47] Anonymous, "McDonald's opens 300th outlet", *The Korea Times*, 20 November 2001.
[48] Anonymous, "McDonald's 'glocalization' drive appealing to Koreans", *The Korea Times*, 16 January 2002.

and treatment of its employees. "Women employees, in particular, expressed considerable satisfaction with McDonald's openness and relative lack of hierarchy, which in their view led to greater gender equality than is normally the case in Korean business circles." [49] As unemployment levels rose after 1998, an increasing number of women sought employment in the food service industry, and foreign firms seemed to provide the best advancement opportunities. McDonald's is a clear leader in this respect. Out of 140 branch managers in the ShinMc region (Seoul, Kyonggi, and Choongchung provinces), 60 were female. Of this number, 44 had been promoted as managers after joining the company, while the other 16 began their careers as part-time employees.[50] The company also implemented a program in 2001 to hire disabled workers in its outlets. With the assistance of the Korean Employment Promotion Agency for the Disabled, it hired 33 disabled workers on a four-week trial basis. Twenty of the trial workers were later hired to full-time positions, and another eight to part-time jobs, at 17 outlets nationwide. (Interestingly, the idea to hire disabled workers came after McDonald's officials in Korea visited Japan, where the company had successfully implemented a similar policy.)[51]

Such demonstrations of good citizenship are not unusual for McDonald's, but may be particularly beneficial in Korea, where anti-American sentiments still cause occasional problems for the firm (such as a popular boycott effort after a Korean speed skater was controversially disqualified from a race in the 2002 Winter Olympic Games). McDonald's has also suffered official sanctions, such as when the Fair Trade Commission issued an administrative order banning the company from running ads for its Bulgogi Burger on the grounds the ads were misleading. On appeal, a local court upheld

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[49] Bak, Sangmee, *op. cit.*, pages 141-142.
[50] Kin Ji-hyun, "Woman power growing in food service sector", *The Korea Times*, 2 April 2001.
[51] Kim Ki-chan, "McDonald's first chain to hire the disabled", *Joong Ang Ilbo*, 15 November 2001.

the FTC ruling in November 1999, saying "The ads are feared to cause misunderstanding among consumers because it does not mention that the product contains pork," noting that consumers have general understanding that bulgogi is roasted beef, not pork.[52] Consumers, however, seemed not to care what the sandwich was called – even after McDonald's altered its ads (which it presumably did, since the name of the burger was not changed). More recently, McDonald's (among other multinationals) has been incorporating traditional Korean themes, music, and clothing into its advertising in an effort "to remove the distant feeling toward McDonald's products by connecting foreign food and traditional Korean culture."[53]

Given this context, it is hard to overstate the importance of McDonald's local partners in South Korea. Not only have they contributed to a better understanding of the local markets, and to the development of appropriate operating procedures and practices, they have also provided what the chain needs most in answering its critics: a legitimate claim to be a Korean company.

Recalling the early experience of Ahn Hyo Young, as he sought to comply with regulations and obtain the necessary government approvals to open the first McDonald's in South Korea, there are some problems that only a local partner can handle. Who else but an indigenous entrepreneur would possess the cultural sensitivity, local business and political connections, and patience necessary to deal effectively with the latest challenge facing McDonald's in Seoul: a citywide ban against the color red on outdoor signs?[54] [55]

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[52] Anonymous, "McDonald's carries improper ads on hamburger: local court", *The Korea Times*, 25 November 1999.
[53] Lee Chul-ho, "Korean commercials by multinational companies", *Joong Ang Ilbo*, 10 March 2000.
[54] Kim Hoo-ran, "Seeing red", *Joong Ang Ilbo*, 25 November 2001.
[55] Kim Sung-jin, "Firms alert over billboard regulation", *The Korea Times*, 24 January 2002.

INDONESIA

Establishing a Partnership

With its demonstrated success in the other major markets of Southeast Asia, there was no shortage of people who expressed interest in becoming McDonald's partner in Indonesia. The company reportedly received some 14,000 letters of application from people seeking a local franchise.[1] Following a careful screening and evaluation process, McDonald's Corporation finally selected a successful and well-connected businessman as its local partner for Indonesia.

Bambang N. Rachmadi (nicknamed Tony) was born on 15 March 1951. He had earned a Masters of Science degree in banking and finance from the University of California, and later received an MBA from John F. Kennedy University in San Francisco. Upon returning home to Indonesia, he quickly rose to become managing director of PT Bank Dutu in 1978, a position he held until 1986, when he was named president and director of PT Bank Panin.[2]

Eager to pursue more entrepreneurial interests, Rachmadi quit his post at Bank Panin in 1988. He soon set his sights on the commercial radio market, but with an international twist. He recalled that during the cold war, many Western radio stations had developed a large following among people living in Eastern Europe, where all local broadcasts were strictly controlled by the government. People hungry for alternative news, music, and other programming simply tuned in to Western radio broadcasts, which their governments found very difficult to jam. He thought a similar situation existed in

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[1] Roeroe, Freddy, "Bambang N. Rachmadi, lepas predir jadi pelayan", *Kompas*, Indonesia, 11 February 1998.

[2] In Indonesia, the "PT" prefix in a company name stands for "perseroan terbatas", meaning "limited (liability) company or partnership", and is roughly equivalent to the suffix "incorporated or inc." in the United States.

Singapore, where the government controlled both broadcast content (mainly through self-censorship) and management systems. Reasoning that private-sector radio could better match audience tastes, he developed his idea of establishing a radio station on the Indonesian island of Batam to broadcast alternative programming into nearby Singapore.[3]

Through friends acquainted with officials in the Batam Authority, Rachmadi was able to secure a letter of recommendation which he used to obtain a broadcasting license in May 1988. Importantly, the license gave him permission to use both Indonesian and English languages in broadcasts from the border location. After securing his license, and obtaining the necessary equipment, Rachmadi recruited broadcast officials from the Philippines (which already had a lively private-sector, English-language radio market). In September 1988, Rachmadi launched Radio Ramako Batam. Based on American-style programming and management practices, it was almost instant hit with Singaporeans. By December 1988, the station's advertising revenues topped SGD 500,000, SGD 20,000 of which came from McDonald's Singapore.[4]

With a keen eye for potential business opportunities, Bambang N. Rachmadi approached Robert Kwan, Managing Director of McDonald's Singapore, and inquired about the possibility of obtaining the McDonald's franchise rights for Indonesia. Kwan recommended a meeting with Peter Richie, who was then head of McDonald's Australia, and had oversight responsibility for the region. Rachmadi submitted a formal application outlining his business plans and prospects for McDonald's in the Indonesian market. He then persisted with telephone calls nearly every week to follow up on his application.

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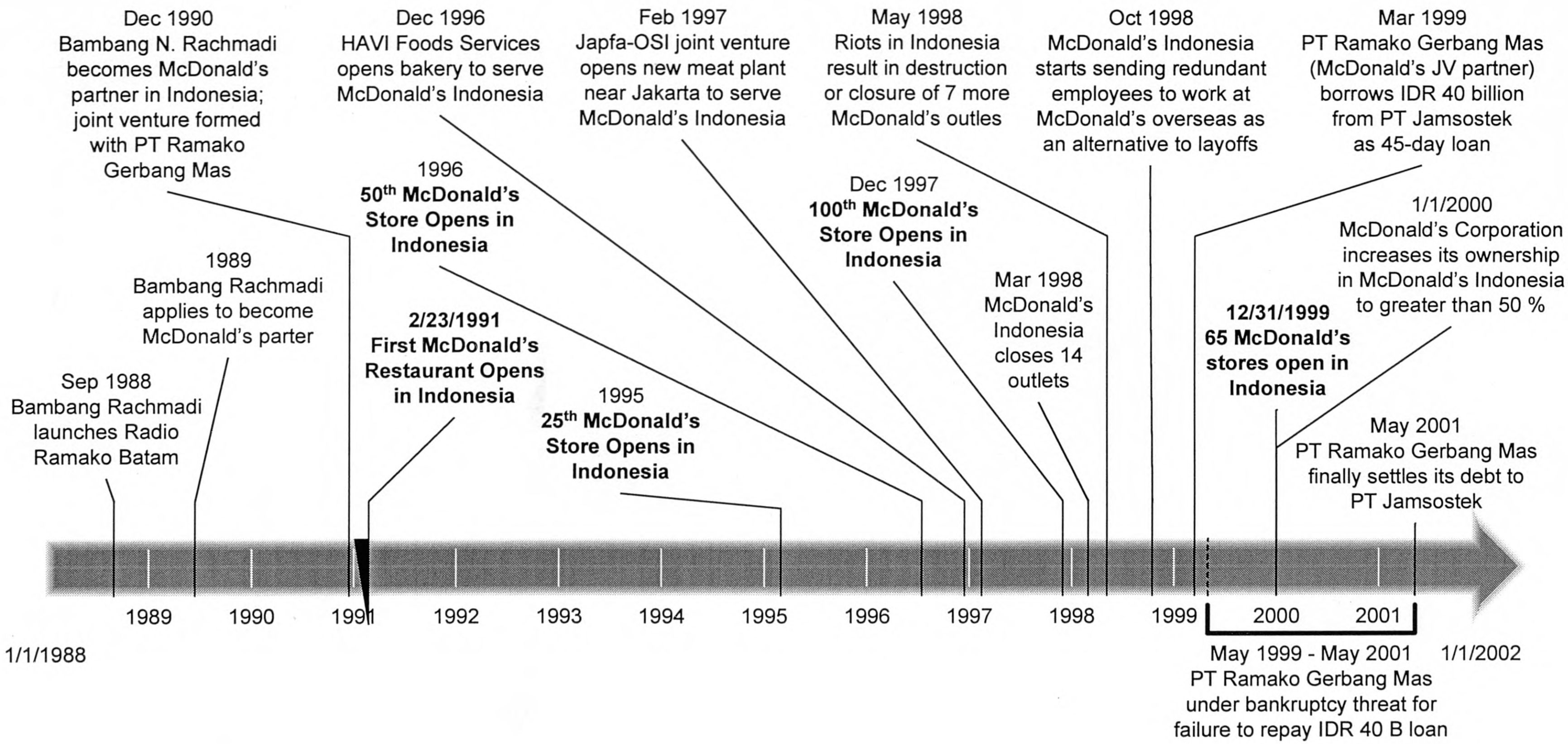
[3] Roeroe, Freddy, "Bambang N. Rachmadi, lepas predir jadi pelayan", *Kompas*, Indonesia, 11 February 1998.
[4] *Ibid.*

Figure 24
McDonalds in Indonesia Timeline



After several months, McDonald's Corporation reduced the number of applications still under consideration from 14,000 to a long list of 40 candidates, which included Rachmadi. More detailed evaluations followed, through which the list was first narrowed to 20 candidates, and then to a short list of three names. Finally, in December 1990, after an eighteen-month selection process, Bambang N. Rachmadi received notice that he was McDonald's first choice.[5]

Like McDonald's other local partners, Rachmadi had to undergo an on-the-job evaluation as part of the selection process. He worked for three days at a McDonald's restaurant in Singapore performing various tasks, including washing the toilets, alongside regular employees. Obviously concerned about passing this evaluation, Bambang said he enlisted the support of his youngest brother, who accompanied him to Singapore with the special assignment of making sure that he did not oversleep and arrive late for work.[6] Accounts differ as to the amount of additional training that Bambang Rachmadi received, but according to McDonald's Indonesia, he underwent one year of training in Australia, America, Malaysia and Singapore before he opened his first restaurant on 23 February 1991.[7] How he managed to squeeze one year of training into a couple of months, while continuing to look after his other businesses, was not explained – unless he was actually selected as McDonald's partner much earlier than in December 1990 (as he himself said).

Specific details concerning the original organizational structure and ownership of McDonald's operations in Indonesia could not be confirmed. In the local press Bambang N. Rachmadi is usually identified as principal owner of PT Ramako Gerbang Mas, a local

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[5] Roeroe, Freddy, "Bambang N. Rachmadi, lepas predir jadi pelayan", *Kompas*, Indonesia, 11 February 1998.
[6] *Ibid.*
[7] McDonald's Indonesia, downloaded from <www.mcdonalds.co.id/inside_McD/our_history.html>

company that owns the master franchise rights for McDonald's in Indonesia.[8][9] However, other evidence, including McDonald's business practices elsewhere in the region, would suggest that McDonald's Corporation initially formed a local joint venture company, perhaps with P.T. Ramako Gerbang Mas as its joint venture partner, and this joint venture actually owned the master franchise rights in Indonesia. For example, the McDonald's Indonesia website (which is mostly in the Indonesian language) presents a brief history of the local operations in which Bambang N. Rachmadi is identified as founder, president and director, but it makes no mention of PT Ramako Gerbang Mas. The copyright holder of the website is identified as 'McDonald's Indonesia', suggesting this is a distinct legal entity.[10] Other sources have also identified 'McDonald's Indonesia' as an independent entity, without reference to either PT Ramako Gerbang Mas or Bambang N. Rachmadi.

From information contained in McDonald's Corporation annual reports, it appears that PT Ramako Gerbang Mas (perhaps along with other local parties) initially owned a majority stake in McDonald's Indonesia. It was not until the first quarter of 2000 that McDonald's Corporation began to consolidate the results from Indonesia in its financial reporting; prior to this the local organization was still an affiliate (i.e., owned 50 percent or less by McDonald's).[11] Based on it practices elsewhere in the region, it seems likely that McDonald's Corporation's original stake in Indonesia was either 50 or 49 percent, but this has not been confirmed.

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[8] Anonymous, "Fast-food franchise business: Its condition and developments; Part 1 of 2 Parts", *Indonesian Commercial Newsletter*, Volume XXIII, Number 234, 22 December 1997, page 7.
[9] In the Indonesian language, the word *gerbang* means gateway or arch, especially in reference to ceremonial arches, while the word *mas* is a contraction of *emas*, which means gold. Thus, the local company name would be translated as 'Ramako Golden Arches'. (It might also be translated as 'Ramako Golden Gate', in possible reference to the San Francisco bay area, where Bambang N. Rachmadi received his advanced academic degrees.)
[10] McDonald's Indonesia, downloaded from <www.mcdonalds.co.id>
[11] McDonald's Corporation Annual Report 2000.

Another area of some confusion is the ownership of PT Ramako Gerbang Mas. While most reports say the company, along with others in the 'Ramako Group', is owned and managed by Bambang N. Rachmadi, others suggest a wider shareholding among his family members, in particular his wife.[12] One source even claims these businesses, while managed by Bambang and his brother Harry, are actually controlled by family members of retired Lieutenant General Sucharmono, Bambang Rachmadi's father in law.[13] [14] (The same source claims the Sudharmono's family controls other businesses usually associated with Rachmadi, including Bank Panin and IFI Bank.)

One fact is clear: at the time he entered into business with McDonald's, Bambang N. Rachmadi was politically well-connected as a result of his marriage to Sudharmono's eldest daughter, Sri Adyanti.[15] As chairman of the ruling Golkar (Golongan Karya) party from 1983 to 1988, and Vice President of Indonesia from 1988 to 1992, Sudharmono was in a position to assist his son-in-law as he was establishing both his broadcasting and McDonald's businesses. Whether or not Sudharmono (or members of his family) ever held any equity interest in these businesses, it is possible that his connections provided critical assistance in obtaining the permits, approvals, or loans necessary to launch them. At the very least, such a recognizable family connection may have opened some doors that otherwise would have remained closed to Bambang N. Rachmadi.

Given the changes in Indonesian politics since 1997, and the disdain felt by many toward Golkar and former president Suharto, it is easy to question McDonald's choice of

[12] Anonymous, "Jamsostek berencana pailitkan McDonald's", *Saura Merdeka*, 8 December 2000.
[13] Aditjondro, George J., "Autumn of the partiarch: The Suharto grip on indonesia's wealth", *The Multinational Monitor*, Volume 19, Numbers 1 & 2, January/February 1998; from <www.corpwatch.org>.
[14] Aditjondro, George J., "US business links of the Suharto and Habbie families and their cronies", Part 2 of 3, July 1998, downloaded from: <www.icsea.or.id/sea-span/0798/OT0819LL.htm>.
[15] Roeroe, Freddy, "Bambang N. Rachmadi, lepas predir jadi pelayan", *Kompas*, Indonesia, 11 February 1998.

a local partner in Indonesia. However, one must put the Sudharmono family connection in proper perspective. Indonesia, the world's fourth most populous country, has enormous potential for McDonald's, and from its experience elsewhere in Asia, early market entry seemed a key to long-term success. With other chains starting to move into Asia by the late 1980s, the company could not afford to delay entry into Indonesia. Being realistic, it would have been extremely difficult (perhaps even impossible) for McDonald's to enter Indonesia in the early 1990s without having a local partner who was somehow connected to both Golkar and Suharto.

Quite aside from any possible social concerns or moral reservations, this reality posed a dilemma for McDonald's Corporation. On the one hand, McDonald's prefers to partner with individual entrepreneurs who are willing to commit themselves exclusively to running their McDonald's business. On the other hand, the company knew that its prospects for a successful market entry were much greater with an established and politically connected local partner – yet such individuals rarely limit themselves to a single business pursuit. Obviously, the company believed its choice of Bambang N. Rachmadi represented the best possible compromise between these concerns. It is not surprising, however, that Rachmadi remained actively involved in the management of several other ventures, including the radio broadcasting businesses of Ramako Group, throughout the initial years of McDonald's operations in Indonesia.

Building the Business

Given the concerns that McDonald's Corporation must have felt about a potential partner with so many competing interests, it seems clear that in addition to his proven business acumen, dogged determination, and obvious political connections, Bambang N.

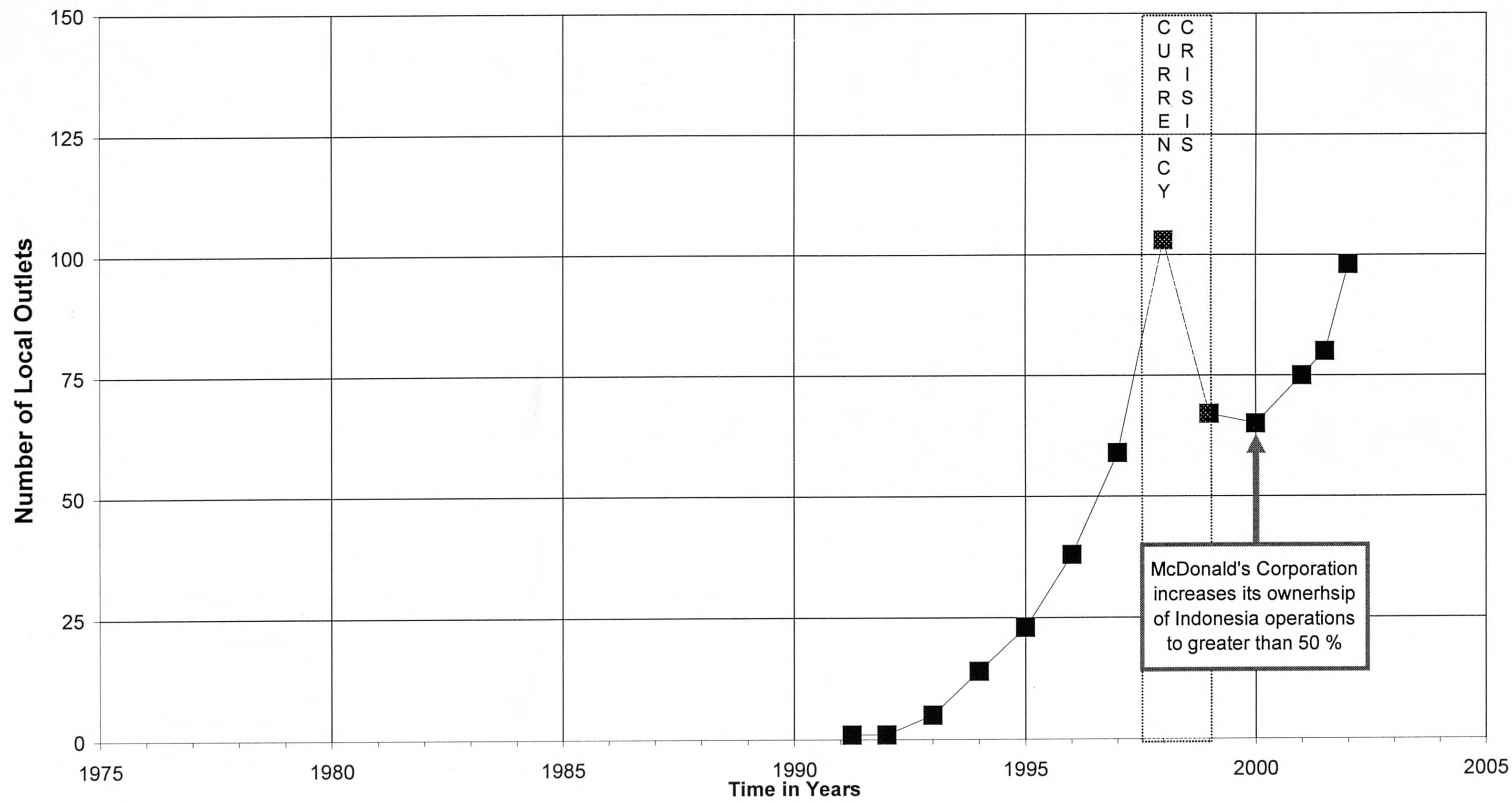
Rachmadi was selected on the strength of his business plan. A key element of that plan must have been the development of a strong local management team to run McDonald's Indonesia. One of the first members of that team was Budi Karsono, a Jakarta native who had left Indonesia in 1981 to attend university in England. While there, he worked for some time as a McDonald's crew member. Upon returning to Indonesia in 1990, he taught English until he answered Bambang Rachmadi's ad for local managers to help run McDonald's Indonesia. He was hired and underwent a year of training at McDonald's in Singapore prior to the official opening of the first McDonald's store in Jakarta. In fact, Karsono's training curiously parallels that reportedly received by Bambang Rachmadi.

Is it possible that Budi Karsono was actually the person who received the in-depth management training accredited to Rachmadi, with an understanding between the joint venture partners that Karsono would be the one with hands on responsibility for running McDonald's business in Indonesia? This is only speculation, but it is consistent with the established facts and would explain why McDonald's tolerated Rachmadi's continued involvement in his other business activities during the critical early years of McDonald's development in Indonesia. As further evidence of Karsono's status in the McDonald's System, he was subsequently hired as a professor at McDonald's Hamburger University in Chicago in 1996.[16] As Bambang Rachmadi earlier demonstrated when establishing his radio business, he at least knew how to find the experienced managerial talent necessary to make McDonald's successful.

McDonald's Indonesia opened its first restaurant on 23 February 1991. As elsewhere in Southeast Asia, the chain grew slowly at first. It was early 1992 before a

[16] Redana, Bre, "Profesor hamburger Budi Karsono", *Kompas*, Indonesia, 15 May 1996.

Figure 25
McDonald's Unit Growth in Indonesia



second store opened, and by the end of the 1992, there were just five were outlets in operation. Then, as shown in Figure 25, the rate of expansion increased. Nine new stores were opened in both 1993 and 1994, and 15 more were added during 1995. In January 1996, the company announced plans to build another 20 outlets that year, representing an investment of IDR 20 billion.[17]

By the end of December 1996, the number of McDonald's outlets in Indonesia reached 59 (and increase of 21 over the previous year). Most were located in Jabotabek, the metropolis of Jakarta and its satellite cities (Bogor, Tangerang, and Bekasi) but more than a dozen stores had also been opened in other cities, including Surabaya, Denpasar, Bandung, Malang, Cirebon, Semarang, and Yogyakarta.[18] McDonald's Indonesia's sales in 1996 hit IDR 170 billion (then about USD 72 million).[19] Encouraged by its prospects for further growth, the company announced plans in January 1997 for another 30 outlets to be built that year, at an additional investment of IDR 35 billion. For the first time, some of these new outlets would be located outside of Java and Bali, in the larger cities on the island of Sumatra.[20]

It is not clear what role, if any, sub-franchising played in the early growth of McDonald's Indonesia, or whether the aggressive expansion plans announced in early 1997 included possible sub-franchising of new outlets in Sumatra or elsewhere. No specific references have been found to confirm that any McDonald's units in Indonesia have ever been sub-franchised; all appear to be fully owned and operated by McDonald's

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[17] Anonymous, "PT Gerbangmas will invest about Rp 20 billion on 20 new McDonald's outlets", *Indonesian Investment Highlights*, Indonesia, Number 73, January 1996, page 7.
[18] Anonymous (TB), "McDonald's sumbang 80 hewan kurban", *Bisnis Indonesia*, 19 April 1997.
[19] Anonymous (K24/ARD), "McDonald's revisi volume penjualan", *Bisnis Indonesia*, 1 December 1997.
[20] Anonymous (TB), "McDonald's tambah 30 outlet tahun ini", *Bisnis Indonesia*, 25 January 1997.

Indonesia.[21] However, in a general article on the fast-food franchising business in Indonesia (published in December 1997), is was emphasized that Bambang N. Rachmadi, unlike most other fast-food developers, also has master franchising rights for McDonald's and can thus award sub-franchises. The article continues:

> To be able to open a McDonald's outlet in Indonesia, an independent franchisee has to prepare IDR 2.5 billion in funds. These funds are to be used to finance the provision of training, the construction of the outlet, the procurement of basic materials, the provision of working capital, the advertisement, and the payment of the initial fee. The rate of business success with McDonald's is estimated at close to 100%. McDonald's requires that its franchisees shall be indigenous businessmen, that they shall undergo 12 months of training, and that they shall fully (100%) concentrate on developing their McDonald's outlets. This means that a McDonald's franchisee is not allowed to do other business activities.[22]

This information, which must have come from a company press release, reads almost like an advertisement, and suggests McDonald's was considering franchising in the future.[23]

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[21] One source quotes a local 'franchise consultant' who makes a confused argument that both McDonald's and KFC violate at least the spirit of Indonesia's Anti-Monopoly Law because neither has sub-franchised any of its outlets in Indonesia (and they are dominate in the fast food market): Anonymous, "McDonald's & KFC have the potential to apply monopoly", *Bisnis Indonesia*, 2 July 2001.

[22] Anonymous, "Fast-food franchise business: Its condition and developments; Part 2 of 2 Parts", *Indonesian Commercial Newsletter*, Volume XXIII, Number 234, 22 December 1997, page 13.

[23] An extensive internet search for information on McDonald's Indonesia produced the name of one other local entity (besides PT Ramako Gerbang Mas) that is directly affiliated with McDonald's Indonesia. The site of a Jakarta-based IT company, Benetic Sistem Informasi <www.benetic.com>, listed among its clients "PT Bintang Rama Mandiri (McDonald's Indonesia)". A subsequent search for information on PT Bintang Rama Mandiri resulted in two hits. One was a website for the East Java branch offices of Askes, an Indonesian health insurance provider, that listed PT Bintang Rama Mandiri among its 'friends' in Surabaya <www.askesjatim.com/mitra.php>. Seven local McDonald's outlets were also on the list, as branch locations of PT Bintang Rama Mandiri. The other hit was the McDonald's Brazil website, which presents contact information for country-specific inquiries about McDonald's international franchise opportunities <http://www.mcdonalds.com.br/franquia/cont_exterior.shtml>. The only entry for Indonesia was "Iman Tjiptadi, Franchising Manager, PT Bintang Rama Mandiri", with a Jakarta address identical to that of McDonald's Indonesia. Iman Tjiptadi (without reference to PT Bintang Rama Mandiri) was also listed on McDonald's Corporation's website <www.mcdonalds.com> as the contact person for franchising in Indonesia. It thus seems likely that PT Bintang Rama Mandiri is merely a local contractor who provides human resources and other services to McDonald's Indonesia.

It is not known whether any individual franchises were awarded in Indonesia, but the company was definitely pursuing business alliances to facilitate the opening of new outlets. In November 1997 McDonald's Indonesia announced a strategic alliance with Sun Motors, which operates a large chain of automobile dealerships. Under the agreement, 70 new McDonald's outlets were to be opened in Sun Motor showrooms.[24] From McDonald's perspective, the deal would allow it to expand more rapidly, and at lower cost, given the tight real estate market that prevailed in most urban areas.[25] Details of the agreement were not made public, and it is unknown whether Sun Motors was to take over operation of McDonald's stores located in its premises on a franchise basis.

Other changes were underway by early 1997, as McDonald's Indonesia prepared itself for even more rapid growth. An important element of the company's strategy was to expand its domestic supplier base. As a first step, one of McDonald's international suppliers, Havi Foods Services, opened a plant in Bekasi to supply the chain with baked goods. An investment valued at IDR 12 billion, the plant began operating in December 1996, and was eventually expected to meet McDonald's total requirement of 80,000 buns per day. This not only provided a guaranteed supply of high quality baked goods, it also helped to increase the local content of McDonald's hamburgers from 40 to 60 percent.[26][27]

Another new plant was built in Tangerang (west of Jakarta) to produce hamburger patties for McDonald's. Initially, this plant was to be supplied with frozen meat blocks imported from Australia, but the company said it planned to begin importing live cattle for butchering locally in Indonesia. This would improve the reliability of supply and

[24] Anonymous (TB/ASM), "McDonald's buka 70 cabang di Sun Motor", *Bisnis Indonesia*, 18 November 1997.
[25] Anonymous (ASM), "Aliansi McDonald's – Sun Motor kembangkan usaha", *Bisnis Indonesia*, 5 December 1997.
[26] Anonymous, "Strategi McDonald's rambah pasar RI", *Bisnis Indonesia*, 10 December 1996.
[27] Anonymous (TB), "McDonald's tambah 30 outlet tahun ini", *Bisnis Indonesia*, 25 January 1997.

increase McDonald's local content. The IDR 10 billion meat processing plant opened in late February 1997, with an initial capacity of one ton per hour.[28] Local news reports identified this plant as being owned by McDonald's Indonesia, but it seems more likely that one of McDonald's international suppliers actually made this investment, perhaps in partnership with a local firm. Further investigation revealed the OSI Group has a local operation in Indonesia that produces chicken patties, frozen beef patties, and fish portions. Named PT Japfa-OSI Food Industries, this is apparently a joint venture (similar to GENOSI in the Philippines) between OSI and PT Japfa Comfeed Indonesia, a regional integrated agri-foods company based in Indonesia.[29] Perhaps not coincidentally, it was another OSI Group company, Glovers Food Processors in New Zealand, that had initially supplied the beef patties to McDonald's in Indonesia, from its NZD 5 million plant that was opened in 1992.[30]

When McDonald's entered Indonesia, it organized a network of local farmers to supply it with lettuce and other fresh produce. In 1991, after reviewing a number of potential suppliers, McDonald's selected a local actor named Hachainul (Inul) and his partner Hari Harjianto (Ike) to help coordinate the activities of farmers in Lembang. To ensure that its high quality standards could be met, McDonald's Indonesia reportedly built a processing plant near Lembang that was then handed over to Ike and Ikul. Initially, the cooperative supplied just ten kilograms per day of lettuce to McDonald's Indonesia, but by 1997 the requirements had risen to 16 tons per month.[31] With some 60 farmers and 300 hectares of land (most of these farmers owned only about 5000 square

[28] *Ibid.*
[29] This connection between OSI and Japfa is based on information obtained from the OSI Group's website: <www.osigroup.com/Japfa.htm> and the website of Japfa Comfeed Indonesia: <www.japfacomfeed.co.id>.
[30] Anonymous, "A million patties and growing", Food Technology in New Zealand, August 1992, page 3.
[31] Sasmito, Edy, "McDonald's rangkul petani lembang", *Bisnis Indonesia*, 28 June 1997.

meters of land), the cooperative was able to produce up to two tons of lettuce per day (about 60 tons per month).[32] To assist his local suppliers in utilizing this excess capacity (and thus to lower his own costs), Bambang N. Rachmadi approached other McDonalds's operations in Singapore, Hong Kong, and Malaysia in June 1997 with a proposal that they buy their lettuce from Indonesia. At the time, Australia was supplying about 40 tons of lettuce per week to those countries, at a higher price.[33]

By all appearances, the McDonald's organization in Indonesia was a model of success, having grown from one to more than a hundred outlets within six years, while greatly expanding is local supplier base in the process. As further evidence of the local company's good standing within the McDonald's system, Indonesia was chosen as the location for on-the-job training of McDonald's workers from India, prior to the chain's 1996 launch in that country.[34]

Crisis Response

At its beginning, the year 1997 seemed to hold great promise for McDonald's Indonesia. The company set its sales target at IDR 280 to 300 billion, up 70 percent from sales of IDR 170 billion in 1996.[35] Adding new units was obviously the key to sales growth, and the company decided to commit even greater resources to its already aggressive expansion plans. By early December 1997 it was reported that some 40 new outlets had been opened in 1997, at a total investment of IDR 100 billion.[36] Comparing these figures to the plans announced earlier that year, which called for 30 new outlets at a

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[32] Anonymous. "Lembang pasok kebutuhan McDonald's", *Bisnis Indonesia*, 18 June 1997.
[33] Sasmito, Edy, "McDonald's rangkul petani lembang", *Bisnis Indonesia*, 28 June 1997.
[34] Anonymous, "Nama dan peristiwa", *Kompas*, Indonesia, 12 April 1996.
[35] Anonymous (K24/ARD), "McDonald's revisi volume penjualan", *Bisnis Indonesia*, 1 December 1997.
[36] *Ibid.*

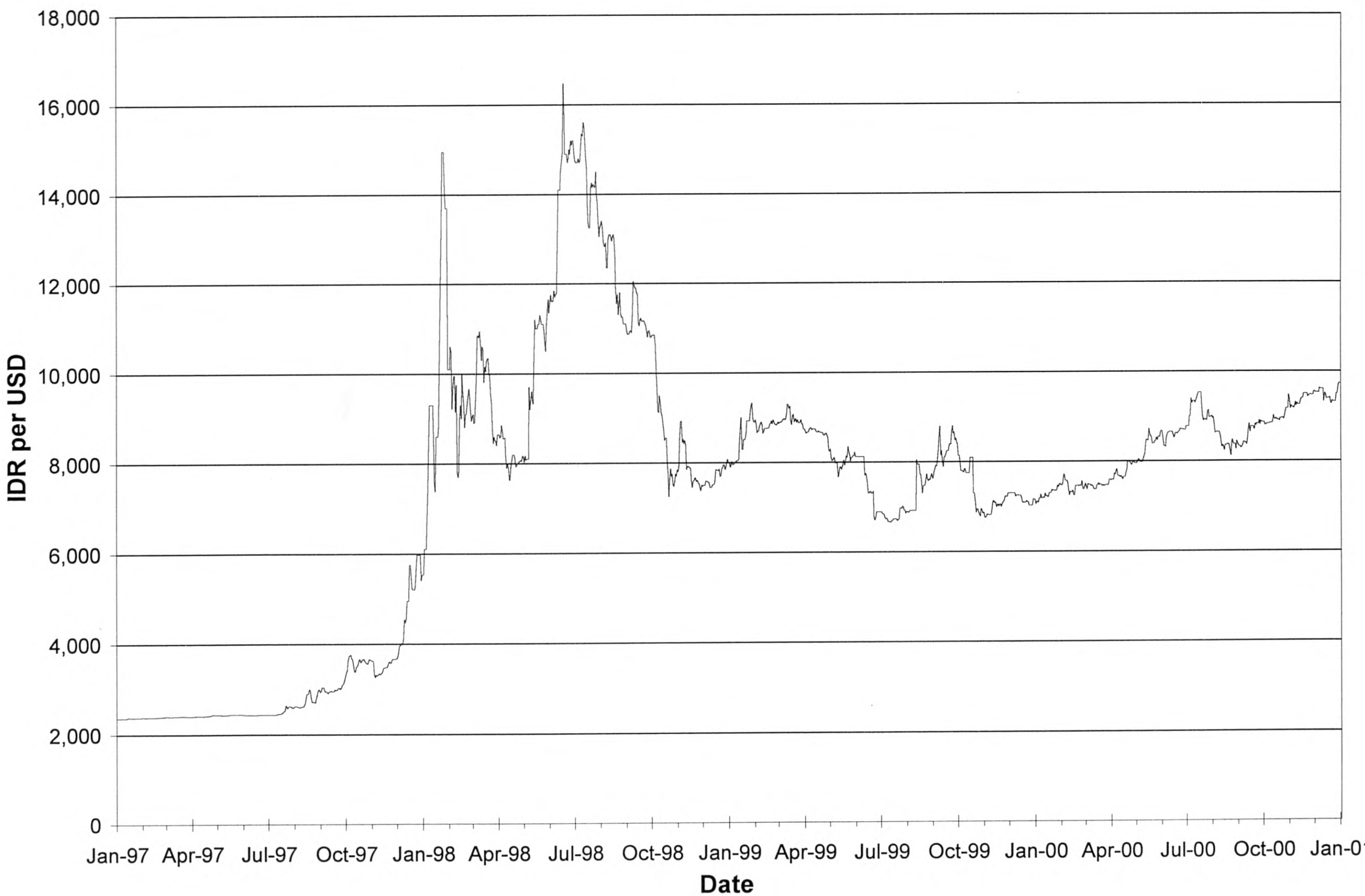
cost of IDR 35 billion, it seems the per unit costs of expansion were much higher than anticipated.[37] This may have been partly due to higher costs of imported equipment in the wake of the currency crisis that hit Southeast Asia in the second half of 1997.

The problem for McDonald's Indonesia was that the currency devaluation and economic downturn were not anticipated, and thus not incorporated into the company's plans. From early July to late November 1997, the Indonesian Rupiah lost over a third of its value against the U.S. Dollar, as shown in Figure 26. By the end of November 1997, McDonald's had 86 outlets throughout Indonesia, up from 59 at the start of the year. Just one month later there were over 100.[38] (According to the McDonald's Corporation 1997 Annual Report, the number of outlets in Indonesia at year's end was 103.) The company said it had been impossible to halt development projects that were already underway when the currency crisis hit.[39] At the time, however, local management still remained quite optimistic. On 1 December 1997, it was reported that McDonald's Indonesia was planning to open 14 new stores in 11 different cities during 1998, an investment then estimated at IDR 35 billion. And this announcement came after the firm sharply reduced its sales and profit targets for 1997 (although the company claimed that it still remained profitable).[40] The management of McDonald's Indonesia obviously believed a strong recovery was just around the corner.

Things changed quickly, however, as the Indonesian Rupiah continued to depreciate (see Figure26). By early December 1997, the U.S. Dollar exchange rate was IDR 4,000, down from an average value of IDR 2,400 during the first six months of the

[37] Anonymous (TB), "McDonald's tambah 30 outlet tahun ini", *Bisnis Indonesia*, 25 January 1997.
[38] Anonymous (TB), "McDonald's buka cabang ke-100", *Bisnis Indonesia*, 31 December 1997.
[39] Anonymous (IM/TIS), "Terobosan McDonald's di tengah krisis", *Bisnis Indonesia*, 7 August 1998.
[40] Anonymous (K24/ARD), "McDonald's revisi volume penjualan", *Bisnis Indonesia*, 1 December 1997.

Figure 26
Indonesian Rupiah - US Dollar Exchange Rates
(1997 - 2000)



year. One month later, it fell below IDR 6,000, and then quickly plummeted to nearly IDR 13,000. Even though the currency recovered a bit by early February 1998, and then seemed to stabilize for the next three months around an average exchange rate of IDR 8,800, serious concerns remained about its volatility. Obviously, firms with significant import requirements or foreign-denominated debts were in big trouble. And it appears McDonald's Indonesia – or at least its local partner – was among these.

Not only did McDonald's shelve its plans for further expansion in Indonesia, the firm also announced in late January 1998 that it might close some outlets in locations where its rent was settled in U.S. Dollars. The company that said it was attempting to negotiate conversion of such leases to the local currency, but if property owners refused, it would have no choice but to close some locations.[41] With so many other businesses affected by the currency devaluation, it came as no surprise when McDonald's closed 14 of its outlets in Jakarta on 1 March 1998.[42] Another blow came in May 1998, when riots broke out in Jakarta and other urban areas – a result of long-simmering frustrations over the economy and Indonesia's political leadership. Western fast-food outlets and other businesses (especially those owned by ethnic Chinese) became targets of popular rage and were temporarily forced to close their doors.[43] Some never reopened, and many were physically destroyed by rioting, looting, and arson, including six McDonald's outlets in Jakarta and other cities.[44] [45] This raised to 20 the number of McDonald's restaurants that

[41] Anonymous, (TB/SAN), "McDonald's akan tutup cabang", *Bisnis Indonesia*, 26 January 1998.
[42] Anonymous, "Omzet turun, McDonald's tutup 14 cabang", *Kompas*, Indonesia, 23 March 1998.
[43] Anonymous, "US fast-food units close amid Indonesian rioting", *Nations Restaurant News*, Volume 32, Number 21, 15 May 1998, page 4.
[44] Anonymous, "McDonald's Indonesia develops crisis plan", *Meat Industry Internet New Service*, Northport, New York, 18 July 1998, downloaded from <www.spcnetwork.com/mii/1998/980739.htm>.
[45] Emond, Bruce, "U.S. franchises strive to rebound from prolonged Indonesia economic woes", *Advertising Age*, International Supplement, 9 November 1998, page 4.

had been closed by mid-1998.[46] McDonald's and other fast-food chains also suffered from general disruption of their food distribution networks throughout the country.[47] However, even bigger challenges facing McDonald's were the high cost of its imported supplies and a shrinking customer base.

Earlier in 1997, imports had accounted for 27 percent of McDonald's product costs, and that percentage rose quickly as inventories were depleted and the Rupiah continued to lose value. In an effort to defend its sales volume, the company initially resisted the urge to raise prices in response to higher import costs.[48] By the end of 1997, however, this policy was unsustainable, and McDonald's Indonesia was finally forced to increase prices. Through the first half of 1998, McDonald's sales did not decrease in Rupiah terms, but the number of transactions had dropped as prices were increased. In less than a year, the price of a Big Mac nearly tripled to IDR 10,400. By comparison, the official minimum daily wage in Jakarta was just IDR 5,750.[49]

McDonald's Indonesia responded with a strategy of offering cheaper, locally made products to compete with meals sold by street vendors at roadside stalls. On 19 December 1997, McDonald's Indonesia launched the Paket Hemat, or economy pack, which consisted of a burger and drink.[50] Notably absent from this combo was the chain's most costly imported food item, french-fried potatoes. As a substitute, local rice was added to the menu, and another value meal was created: the Paket Nasi or rice pack.[51] As

[46] Anonymous, "Ramako Group closed down 20 McDonald outlets during the crisis", *Indonesian Investment Highlights*, Number 103, July 1998, page 6.
[47] Anonymous, "US fast-food units close amid Indonesian rioting", *Nations Restaurant News*, Volume 32, Number 21, 15 May 1998, page 4.
[48] Anonymous (K24/ARD), "McDonald's revisi volume penjualan", *Bisnis Indonesia*, 1 December 1997.
[49] Anonymous, "McDonald's Indonesia develops crisis plan", *Meat Industry Internet New Service*, Northport, New York, 18 July 1998, downloaded from <www.spcnetwork.com/mii/1998/980739.htm>.
[50] Anonymous (IM/TIS), "Terobosan McDonald's di tengah krisis", *Bisnis Indonesia*, 7 August 1998.
[51] Anonymous, "Omzet turun, McDonald's tutup 14 cabang", *Kompas*, Indonesia, 23 March 1998.

elsewhere in Southeast Asia, McDonald's consumer surveys showed most Indonesians like chicken, which had the advantage of being locally available. The company therefore introduced a new chicken and rice meal on 27 February 1998.[52] Another new product, the 'Rice Egg' was introduced in early July 1998. The single-egg omelet on a cake of rice cost just IDR 2000, making it one of the cheapest meals available anywhere.[53] Other product innovations have since followed, such as the introduction of McSatay, based on a traditional Indonesian barbecued meat dish, and McWings, a four-piece fried chicken wing meal, which make use of locally supplied foods.[54]

Of course, McDonald's Corporation had to approve these new menu items, but according to Bambang Rachmadi, all of the changes were negotiated in advance.[55] No doubt McDonald's Corporation also drew on its experience in other Asian countries to assist in the development of the new products. As Rachmadi explained, "we have more new products up in our test kitchen and ready to move any time. This will be our answer to the situation – good nutritious products with quality, but affordable."[56]

McDonald's suppliers also helped in dealing with the crisis. In July 1998, Rachmadi was quoted as saying, "Fortunately, in the McDonald's system the supplier is a very important part of our system. We have long-term suppliers who are with us." He added that McDonald's suppliers were currently charging just 'development prices', which he defined as basic food costs with no extra charges.[57]

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[52] Anonymous (IM/TIS), "Terobosan McDonald's di tengah krisis", *Bisnis Indonesia*, 7 August 1998.
[53] Anonymous, "McDonald's Indonesia develops crisis plan", *Meat Industry Internet New Service*, Northport, New York, 18 July 1998, downloaded from <www.spcnetwork.com/mii/1998/980739.htm>.
[54] Anonymous (NMS), "McDonald's tutup 28 restoran", *Bisnis Indonesia*, 5 June 1999.
[55] Anonymous (IM/TIS), "Terobosan McDonald's di tengah krisis", *Bisnis Indonesia*, 7 August 1998.
[56] Anonymous, "McDonald's Indonesia develops crisis plan", *Meat Industry Internet New Service*, Northport, New York, 18 July 1998, downloaded from <www.spcnetwork.com/mii/1998/980739.htm>.
[57] Anonymous, "McDonald's Indonesia develops crisis plan", *Meat Industry Internet New Service*, Northport, New York, 18 July 1998, downloaded from <www.spcnetwork.com/mii/1998/980739.htm>.

McDonald's also found an interesting solution to the problem of some 2200 employees who found themselves out of work when their stores closed in 1998.[58] It initiated a program to send some of the laid-off employees to work at McDonald's outlets in other countries. In early October 1998, the first group of 23 crew and 16 swing managers were sent from Indonesia to work at 19 McDonald's outlets in Kuwait.[59] They received a two-year contract with a monthly salary in the range of USD 215 to USD 250 for crew and USD 485 to USD 1000 for managers (considerably higher than McDonald's salaries in Indonesia). Subsequent groups were sent to other countries in the Middle East and to the United States. All were employed by McDonald's, and received free transportation, housing, health benefits, and bonuses in addition to their salary.

By June 1999, McDonald's Indonesia had sent 115 employees abroad, most on three-year work contracts, as it announced plans to send another 100 workers to Saudi Arabia. According to Bambang Rachmadi, his company received nothing either from the workers themselves or the foreign outlets for sending its employees abroad.[60] Of course, it was expected that most of these workers would eventually return to Indonesia, and bring with them both gratitude to McDonald's Indonesia for providing a high-paying employment opportunity during the economic crisis and additional years of work experience in the McDonald's system. Therefore, at little cost to his own operation, Bambang Rachmadi was able to ensure a potential supply of loyal managers who would support the long-term growth of McDonald's in Indonesia.

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[58] Anonymous, "McDonald's Indonesia to send more staff abroad: Bambang", *The Jakarta Post*, 26 June 2001.
[59] Anonymous (ESA), "Omzet McDonald's meningkat 30%", *Bisnis Indonesia*, Jakarta, 5 October 1998.
[60] Anonymous, "McDonald's Indonesia to send more staff abroad: Bambang", *The Jakarta Post*, 5 June 1999.

From its inception in 1991 to the end of 1997, McDonald's Indonesia had focused on unit growth to expand (and defend) its share of the local fast food market. During 1998 the company changed its strategy to optimizing the performance of existing units – and closing less productive outlets.[61] As reported by McDonald's Corporation, just 67 outlets remained in operation at the end of December 1998, down from 103 one year before.[62] The introduction of low-priced menu items with greater local content (as earlier discussed) was another important key to making this retrenchment strategy work.

As one measure of its success in responding to the crisis, McDonald's turnover in the first nine months of 1998 was 30 percent higher than for the same period in 1997.[63] In November 1998, Bambang Rachmadi announced that sales for 1998 were projected to top IDR 200 billion, a significant increase over sales of IDR 170 billion in 1997.[64] McDonald's same-store sales continued to improve the following year. In June 1999, the firm reported turnover was up 45 percent compared to the previous year, with same-store sales up as much as 200 percent.[65] Without providing any specific figures, McDonald's Indonesia later reported (in January 2000) that sales at individual outlets had risen by an average of 150 percent in 1999.[66] [67] Since the company finished 1999 with roughly the same number of outlets as in 1998, this implies its 1999 turnover was at least IDR 300 billion.[68] Sales growth continued to improve in early 2000. By mid-year, McDonald's

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[61] Anonymous (IM/TIS), "Terobosan McDonald's di tengah krisis", *Bisnis Indonesia*, 7 August 1998.
[62] McDonald's Corporation, Annual Reports 1997 and 1998. Other sources report fewer store closings during 1998 (most place the number of outlets closed at 28 or 30), but also report a smaller number of outlets operating at the end of 1997 (typically either 98 or 100). In light of this, the figures reported by McDonald's Corporation are considered to be the most accurate.
[63] Anonymous (ESA), "Omzet McDonald's meningkat 30%", *Bisnis Indonesia*, 5 October 1998.
[64] Anonymous (AF), "McDonald's targetkan omzet Rp 200 miliar", *Bisnis Indonesia*, 6 November 1998.
[65] Anonymous (NMS), "McDonald's tutup 28 restoran", *Bisnis Indonesia*, 5 June 1999.
[66] Anonymous, "Kronika publik: Omzet McDonald's naik 150%", *Bisnis Indonesia*, 4 January 2000.
[67] Anonymous, "McDonald's Indonesia to open 10 more outlets this year", *Asia Pulse*, 4 January 2000.
[68] This calculation was based on an earlier projection (in November 1998) that sales would top IDR 200 billion in 1998; the number of outlets is from McDonald's Corporation's 1998 and 1999 Annual Reports.

Indonesia reported a goal for the year of IDR 700 billion in sales, and said its turnover during the first six months of 2000 was well ahead of target.[69]

Having improved unit performance in 1998 and 1999, McDonald's Indonesia was once again ready to expand its operations through the addition of new outlets. Although new stores were opened during 1999 – most notably in Bali, a popular tourist destination – these were offset by the closure of other stores, which resulted in a net loss of two outlets (from 67 to 65) during 1999.[70] [71] [72] Unit growth resumed only in 2000. In January of that year, the firm announced plans to open 10 new outlets, saying improved security and economic conditions, along with a more stable exchange rate made further expansion both feasible and desirable.[73] By the end of December 2000, McDonald's Indonesia had 75 outlets in operation, thus meeting its goal of 10 new outlets. And in early January 2001 plans were announced to open another 20 outlets.[74] [75]

And Now, The Inside Story

McDonald's Indonesia not only survived currency devaluation, financial crisis, economic downturn, and political upheavals that occurred over the period from 1997 to 2001, it appears to have emerged a stronger, more focused operation that is now

[69] Anonymous, "McDonald's raih Rp 700 miliar", *Bisnis Indonesia*, 11 July 2000.
[70] Anonymous, "Aneka sekilas: McDonald's buka 2 cabang baru tahun ini", *Bisnis Indonesia*, 1 August 1999.
[71] Anonymous, "Niaga sekilas: McDonald's buka gerai di Ngurah Rai", *Bisnis Indonesia*, 22 September 1999.
[72] Local newspaper and magazine reports differed considerably as to the number of outlets McDonald's Indonesia opened, closed, or had remaining in operation during the turbulent period from 1998 to 2000. Consistency could not be found even among different articles in the same publication. However, local press reports (presumably quoting McDonald's Indonesia sources) nearly always gave higher figures for the number of outlets in operation than the year-end figures in McDonald's Corporation Annual Reports.
[73] Anonymous, "McDonald's Indonesia to open 10 more outlets this year", *Asia Pulse*, 4 January 2000.
[74] McDonald's Corporation, <http://www.mcdonalds.com/corporate/investor/about/systemrest/index.html>
[75] Anonymous, "McDonald's plans to open 20 new outlets across Indonesia in 2001", Agence France-Presse, 3 January 2001.

supported by an expanded network of local suppliers. However, the costs of completing this transition were apparently greater than Bambang Rachmadi could personally afford.

In the first quarter of 2000, McDonald's Corporation started including operating results from Indonesia in its consolidated financial reporting.[76] As we have seen before, this marks an effective change to majority ownership by the parent company. Details of the new ownership structure were not made public, and no acknowledgement of any change in ownership appeared in local press reports. To a casual observer McDonald's Indonesia still appeared to be under Bambang Rachmadi's control, through his stake in PT Ramako Gerbang Mas.[77] McDonald's Corporation obviously prefers to maintain the popular impression that its Indonesian operations are locally owned, and such beliefs proved beneficial in reducing potential losses during the riots of May 1998 and again in October 2001 (after American military strikes in Afghanistan). Banners were even hung in some outlets declaring McDonald's is Muslim-owned and Indonesian-owned. Another real concern was the potential for negative public reaction to a foreign company's taking control over locally-owned assets in the wake of the financial crisis. By downplaying the change in ownership structure, McDonald's also helped Bambang Rachmadi to preserve a favorable business reputation (and avoid a loss of face). This final point may have been the major concern, as there is other evidence to support a conclusion that some of Bambang Rachmadi's business interests had become seriously overextended in the wake of the currency devaluation and subsequent financial crisis.

[76] McDonald's Corporation Annual Report 2000.
[77] It is also possible that legal ownership of McDonald's Indonesia did not actually change. Instead, McDonald's Corporation may have extended loans to the joint venture (or directly to its joint venture partner, secured against his stake in the business) that were sufficient to require consolidation in its financial reporting. This appears to be what initially happened in the case of the Philippines, when McDonald's Corporation consolidated that operation in 1998.

Throughout his tenure as McDonald's partner in Indonesia, Bambang Rachmadi has been actively involved in the management of other several businesses, starting with the radio broadcasting arm of the Ramako Group. In June 1996, he returned to banking with the purchase of Bank IFI, which at the time reported assets of IDR 521.8 billion.[78] Less than one year later, in March 1997, Ramako Group took over 100 percent ownership of the troubled Bank Asta (formerly Bina Estana Gemah or BIG Bank), with the help of IDR 50 billion in soft credit from the Bank of Indonesia. (The value of the transaction was not reported, but less than two years earlier, in June 1995, BIG Bank reported assets of IDR 66.5 billion.) The takeover of Bank Asta was reportedly executed to rehabilitate the private bank, which at the time was reported to have bad debts totaling IDR 90 to 100 billion.[79] Within a few months after this purchase, several former directors, managers, and owners of Bank Asta were arrested, presumably at the behest of Ramako Group, in connection with alleged mismanagement and looting of the bank's assets.[80] Given the impending financial crisis, the timing of these purchases probably could not have been worse for Bambang Rachmadi.

Evidence that Ramako Group, and in particular PT Ramako Gerbang Mas, was having financial trouble first appeared in a *Fortune* magazine article in August 1998 which discussed McDonald's Corporation's response to the Asian currency crisis:

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[78] As earlier noted, press references to ownership by Bambang Rachmadi have sometimes obscured the fact that others, including his family members and in-laws, actually hold significant or controlling shares in the business. According to information downloaded from the Bank IFI website <www.ifibank.com/_data/about_us/sejarah.html> in August 2001, Bank IFI is owned by two government banks, Bank Bapindo and Bank BTN, together with two private companies, PT Bernis Sarana Wisma and the Ramako Group (PT Ramako Baru and PT Ramako Media Promosindo). The relative ownership shares are not given, nor is it clear for how long this ownership structure has been in place. However, Bambang N. Rachmadi is listed as one of two vice presidents on the board of directors (dewan komisaris), which includes his wife, Adyanti B.N. Rachmadi. Also, Bambang's brother, Harry Rachmadi one of four members on the management board (dewan direksi).

[79] Anonymous (GPS), "B. Rachmadi beli Bank Asta", *Bisnis Indonesia*, 14 March 1997.

[80] Anonymous, "Scandal at Bank Asta", *Info Bank*, Indonesia, September 1997, downloaded from: <http://infobank-online.com/english/0997/section6.shtml>

> McDonald's has found other ways to take advantage of wild swings in exchange rates. For example, to build its 80 restaurants in Indonesia, it took out millions in construction loans in the local currency. After the rupiah crashed this year, McDonald's was able to pay off those loans at 20 cents to the dollar. "Our assets were devalued, but so was our debt" Cantalupo [president and chief executive officer of McDonald's International] says. He also moved to shore up troubled franchisees in exchange for a greater equity stake in their restaurants.[81]

That McDonald's Corporation did not obtain a majority stake in the local Indonesian operations before 2000 suggests the parent company had moved incrementally to relieve its local partner of debt obligations (or additional capital investments) associated with the business. However, later developments confirmed that PT Ramako Gerbang Mas (or more accurately, other companies in Ramako Group) was in serious financial trouble.

A story broke in September 2000 that PT Ramako Gerbang Mas was overdue in repaying commercial loans it had received from PT Jamsostek (Jaminan Sosial Tenaga Kerja). Jamsostek is a state-owned firm with reported assets of IDR 12.6 trillion (on 31 December 2000) that provides employers with compulsory social security and health insurance coverage for their employees.[82] At the time, Jamsostek had recently undergone a change in management and was projecting an operating deficit for the year, listing PT Ramako Gerbang Mas as one of several firms that were overdue in repaying their loans.[83] From subsequent news reports, it was possible to piece together the sequence of events.

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[81] Kahn, Jeremy, "The world's most admired companies", *Fortune*, 26 October 1998.
[82] Government decrees in 1977 established PT. ASTEK (Employees' Insurance Company) as the only state-owned company to arrange the national employees insurance and protection program. The firm was renamed PT Jamsostek in 1990. Effective 1 July 1992, a new law established a compulsory program for Employers to provide employment accident, death, provident fund, and health care benefits to their employees. source: information downloaded from the PT Jamsostek website: <www.astek.co.id>.
[83] Anonymous, "Tahun ini Jamsostek bisa tekor", *Kontan*, Weekly Edition 1/V, 25 September 2000, downloaded from <www.kontan-online.com/05/01/biskan/bis.htm>.

In March 1999, PT Ramako Gerbang Mas sold to PT Jamsostek promissory notes valued at IDR 40 billion (then equivalent to about USD 4.5 million) with interest of 45 percent per year. The period for liquidation of these notes was promised to be only 40 days.[84] However, with no payments received as of November 2000, and the amount of the outstanding debt calculated at nearly IDR 54 billion (including the accrued interest), Jamsostek threatened to take both Ramako Gerbang Mas and McDonald's to court.[85] [86]

Jamsostek apparently assumed (or perhaps was led to believe) that McDonald's Corporation was backing the loan. Its belief was based on the fact all correspondence from PT Ramako Gerbang Mas pertaining to the promissory note had been written on McDonald's Indonesia letterhead.[87] Whether or not the implied linkage to McDonald's was intentional on the part of Bambang Rachmadi, it is clear that the debts in question were actually the responsibility of Ramako Group and not related McDonald's business in Indonesia.[88] Nevertheless by December 2000, with negotiations nearing a deadlock, news articles began appearing in the local press suggesting that McDonald's Indonesia might be bankrupted as a result of PT Ramako Gerbang Mas' failure to repay its debts.

According to Jamsostek, several attempts had been made to reschedule the loan, with the deadline initially extended for one year to 21 August 2000.[89] When that deadline passed, PT Ramako Gerbang Mas proposed to repay a portion of the debt with a transfer

[84] Anonymous, "Jamsostek berencana pailitkan McDonald's", *Saura Merdeka*, 8 December 2000.
[85] Anonymous, "PT Jamsostek tuntuk McDonald membayar utang", *Kompas*, 1 November 2000, downloaded from <www.kompas.com/wartakota/0011/01/18.htm>.
[86] Hermawan, Deddy, "McDonald nunggak utang Jamsostek Rp 54 miliar", *Tempo*, 24 November 2000, downloaded from <www.tempointeraktif.com/news/2000/11/24/1,1,1,id.html>.
[87] Anonymous, "PT Jamsostek ancam pailitkan McDonald's", *Kompas*, 7 December 2000.
[88] As a further source of confusion, it is possible that McDonald's Indonesia itself previously borrowed funds from PT Jamsostek, and had this established a good credit relationship with the company. One article published in early November 2000 quotes a Jamsostek official who said that up until now McDonald's has always repaid when its debt is due: Anonymous, "PT Jamsostek Tuntuk McDonald Membayar Utang", *Kompas*, 1 November 2000, downloaded from <www.kompas.com/wartakota/0011/01/18.htm>.
[89] Anonymous, "Jamsostek berencana pailitkan McDonald's", *Saura Merdeka*, 8 December 2000.

of land in Kuningan (South Jakarta), and the rest by installments, but Jamsostek said that it preferred to be paid in cash.[90] Apparently, the company was also offered land in Bekasi (east of Jakarta), but claimed in both cases the value of the land was unsuitable and that its legal status was unclear (suggesting PT Ramako Gerbang Mas did not hold a clear and transferable title to the land).[91] [92] PT Ramako Gerbang Mas then submitted a new offer under which it would make an immediate cash payment of IDR 10 billion, and pay the balance of the debt (IDR 44 billion) in installments over a three year period, at an interest rate of just two percent per year. However, that deal also fell through when the IDR 10 billion check handed over by Ramako Gerbang Mas failed to clear the bank.[93] [94] A new deadline of 31 December 2000 was then set for legal action to declare the company bankrupt and seize its assets (which would include its share in McDonald's Indonesia). This deadline was later extended to 31 January 2001.[95]

The next news concerning this matter did not appear until early March 2001, when PT Jamsostek confirmed that it had finally received payment of IDR 10 billion from PT Ramako Gerbang Mas, along with a letter handing over 5400 square meters of land in Kuningan. According to Achmad Djunaidi, managing director of PT Jamsostek, it was better to receive something than nothing.[96] After completing a formal appraisal of the property, a final settlement of the debt was announced in May 2001. Altogether, PT Ramako Gerbang Mas agreed to pay more than IDR 57 billion on the loan of IDR 40

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[90] Anonymous, "PT Jamsostek tuntuk McDonald membayar utang", *Kompas*, 1 November 2000, downloaded from <www.kompas.com/wartakota/0011/01/18.htm>.
[91] Hermawan, Deddy, "McDonald nunggak utang Jamsostek Rp 54 miliar", *Tempo*, 24 November 2000, downloaded from <www.tempointeraktif.com/news/2000/11/24/1,1,1,id.html>.
[92] Anonymous, "Jamsostek berencana pailitkan McDonald's", *Saura Merdeka*, 8 December 2000.
[93] Anonymous, "PT Jamsostek tuntuk McDonald membayar utang", *Kompas*, 1 November 2000, downloaded from <www.kompas.com/wartakota/0011/01/18.htm>.
[94] Anonymous, "Jamsostek berencana pailitkan McDonald's", *Saura Merdeka*, 8 December 2000.
[95] Anonymous, *Bisnis Indonesia*, 22 January 2001.
[96] Anonymous, "Jamsostek akui setor Rp 75 M", *Suara Merdeka*, 3 March 2001.

billion it received just two years before. Final payment was to be effected on 11 May 2001 through a transfer of 5300 square meters of land in Kuningan.[97][98]

In news reports on the final settlement, it was noted that Bambang Rachmadi had refused to transfer a portion of his share in McDonald's Indonesia to settle the debt.[99] However, it seems unlikely the joint venture and franchise agreements with McDonald's would have allowed him to transfer or sell his shares to a third party without approval (and first right of refusal) from the parent company. Perhaps McDonald's Corporation assisted its partner in settling its debt to PT Jamsostek by purchasing (for cash) additional shares in McDonald's Indonesia sometime after it had obtained its majority stake in early 2000. However, the fact that McDonald's has not yet identified its Indonesian operations as being a wholly-owned subsidiary suggests its local partner still owns a minority stake in the business. Whether PT Ramako Gerbang Mas finally avoided bankruptcy has not been determined, but internet searches have failed to turn up any more recent mention of the company.

Meanwhile, McDonald's seems to have gotten back on track in Indonesia. Despite the distractions of its local partner's financial problems, the chain managed to add 10 new outlets in 2000, and more than twice that number were added the following year. Importantly, many of the new outlets were located outside Jakarta, and by late 2001 McDonald's Indonesia had restaurants in 17 cities and 11 provinces.[100] In December

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[97] Anonymous, "Akhir perseteruan McDonald's vs Jamsostek", *Kontan*, Weekly Edition 32/V, 7 May 2001, downloaded from <www.kontan-online.com/05/32/biskan/bis.htm>.
[98] In a subsequent article describing PT Jamsostek's own financial difficulties, it was mentioned that the debts of PT Ramako Gerbang Mas had been settled in June 2001, and that its total payments amounted to IDR 56.89 billion: Irene Koesoetjahjo, "Playing with fire", *IB Magazine*, October 2001, downloaded from <www.ibonweb.com>.
[99] Anonymous, "Akhir perseteruan McDonald's vs Jamsostek", *Kontan*, Weekly Edition 32/V, 7 May 2001, downloaded from <www.kontan-online.com/05/32/biskan/bis.htm>.
[100] McDonald's Indonesia, downloaded from <www.mcdonalds.co.id/inside_McD/store_development.asp>

2001, with a total of 98 outlets in the country, the firm announced plans for another 30 outlets to be added in 2002.[101] It also continued to innovate in its efforts to better suit local tastes. Nine new menu items were introduced in 2001, including McSpaghetti, McIndo, McRice, Tiga Rasa, McWedges, Supermac, Chocop and PaNas Spesial.[102] The company also implemented on-line ordering for several outlets as a feature on its local website.[103] With Bambang N. Rachmadi still actively involved as president and director of McDonald's Indonesia, the company now seems better prepared than ever to challenge KFC's leadership position in the Indonesian fast food market – a market almost everyone agrees has enormous potential.

[101] Anonymous, "McDonald's Indonesia, buka 30 restoran tahun 2002", *Kompas*, Indonesia, 31 December 2001.
[102] Anonymous, "McDonald's buka puluhan restoran selama 2001", *Pikiran Rakyat*, Indonesia, 27 December 2001.
[103] McDonald's Indonesia: <www.mcdonalds.co.id>.

SUMMARY AND CONCLUSIONS

Making generalizations is often hazardous to the truth, especially when they are based on localized business practices across a region as immense and complex as Asia. Important qualifying details will inevitably get lost along the way. Nevertheless, some interesting patterns have emerged from this investigation of McDonald's experience in the region. In keeping with the general themes of this research, the following discussion of results focuses on the company's initial choices regarding local organization, including its relationships with suppliers, and level of foreign direct investment, which determined its local ownership structure. With the benefit of hindsight, these early decisions are on their own interesting to analyze, but it is even more important to review how McDonald's learned from its prior experience, corrected mistakes, and adapted to changing conditions. Finally, it is useful to consider the firm's future prospects in each local market, in light of its current position and past performance.

It is hoped that conclusions drawn from this research will help to provide a better understanding of success factors in other cases of foreign direct investment in Southeast Asia, especially those with franchising as part of their business model. It is also hoped this study will form a foundation for further research on the fast-food industry in Asia.

Local Organization – Joint Venture Partnerships

Early in McDonald's international expansion, the company recognized potential pitfalls associated with a developmental licensing approach and opted instead for direct equity participation. Beginning with Japan, McDonald's entered each new market in

Asia by first establishing a joint venture company with a local individual as its partner.[1] Table 4 presents this experience in summary form.

Except in the Philippines, where the law specifically prohibited foreign ownership of retailing operations, McDonald's joint ventures in Asia have all been established and run as autonomous companies that deal in every aspect of the McDonald's businesses.[2] They buy or lease local properties, develop these sites into retail outlets, and then manage them either as company-operated units or, less commonly, as single-unit franchises that are awarded to local individuals. They establish their own hiring practices, operating procedures, and training programs adapted for their local situation (but which closely follow McDonald's international standards so far as practical). They conduct market research, formulate their own development strategies, make their own pricing decisions, and run promotions and advertising campaigns designed for the local market. They also make their own purchasing decisions (following product quality standards established by the parent company) and work cooperatively in the McDonald's System to encourage both existing and new suppliers to invest in local production facilities to reduce costs, improve product quality, and increase supplier responsiveness to their specific needs. Finally, they work with suppliers to develop new products specifically suited to local tastes and budgets. In effect, each local joint venture company is a reproduction of McDonald's Corporation on a smaller scale.

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[1] This practice changed for the first time when McDonald's entered China in 1990, where it formed joint ventures with agencies of local governments (i.e., state-owned enterprises). However, China seems to be the only exception to the rule. McDonald's subsequent entries into Indonesia (1991), India (1996), Sri Lanak (1998), and Pakistan (1998) were all made using individual entrepreneurs as joint venture partners.

[2] In the Philippines, two separate companies were formed to run the McDonald's business. One was 100% locally-owned with responsibility for retail operations, and functioned much like a multi-unit franchisee. The other was a local joint-venture (which for most of its history, was 40 percent owned by McDonald's Corporation) with responsibility for property ownership and development of new retail locations that were then leased to the operating company. These two companies were merged in 2001, after enactment of the Philippines Retail Trade Liberalization Act removed restriction on foreign ownership of retail operations.

Table 4
McDonald's Local Organizations in Asia

Country Entry Year	Local Partner	Initial Ownership Structure	Subsequent Changes in Ownership and Management Structure
Japan 1971	**Den Fujita** Age: 45 law graduate, local entrepreneur with import-export firm (specializing in brand-name shoes, handbags, apparel)	Joint Venture: **McDonald's Company Japan Ltd** 50% McDonald's Corporation (USA) 50% Fujita & Company Ltd (controlled by Den Fujita) and Daichiya Banking Co. (shares soon bought out by Den Fujita) President and CEO: Den Fujita Operations Manager: John Asahara (from McDonald's Corp)	Early 1992, current ownership structure of **McDonald's Company Japan Ltd** reported to be as follows: 50% McDonald's Corporation (USA) 10% Den Fujita (personal shares) 40% Fujita Shoten (a holding company 70% owned by Den Fujita) 26 July 2001, Initial Public Offering in Japan; new ownership of **McDonald's Co. Japan Ltd**: 50% McDonald's Corporation (USA) 26% Den Fujita (and family members) 24% other public 27 March 2002, Yasuyuki Yagi named president and COO; Den Fujita remains the CEO
Hong Kong 1975	**Daniel Ng Yat Chui** Age: 42 chemical engineer, researcher, turned venture capitalist	Joint Venture: **McDonald's Restaurants Ltd** 67% McDonald's Corporation (USA) 33% Daniel Ng Yat Chui Managing Director: Daniel Ng	April 1995 – McDonald's Corp (USA) exercises its option to buy out Daniel Ng's 33% share, and thus becomes the sole owner of **McDonald's Restaurants Ltd.** Management changes: Don Dempsey named as managing director Daniel Ng named as chairman

Table 4 (cont.)
McDonald's Local Organizations in Asia

Country Entry Year	Local Partner	Initial Ownership Structure	Subsequent Changes in Ownership and Management Structure
Singapore 1979	**Robert Kwan** Age: 28 local entrepreneur (owned bookshop, and toy wholesaling business)	Joint Venture: **McDonald's Restaurants Pvt Ltd** < 50% McDonald's Corporation (USA), actual ownership through subsidiary, McDonald's Restaurants (HK) Ltd.? > 50% Robert Kwan Managing Director: Robert Kwan	During 1997, McDonald's Corporation (USA) increased its ownership of **McDonald's Restaurants (Singapore) Pvt Ltd** to greater than 50%, thus changing it from an affiliate to majority-owned subsidiary. Robert Kwan remains as managing director.
Philippines 1981	**George T. Yang** Age: local entrepreneur with marketing degree and Wharton MBA	Retail Operator: **McGeorge Food Industries, Inc.** (listed by Philippine SEC on 11 February 1980) 100% Filipino-owned (majority control held by George T. Yang and family) Property Owner/Developer: **Golden Arches Development Corporation (GADC).** (est. 16 July 1980 to develop store premises) 29% McDonald's Corporation (USA) 71% George T. Yang and family	November 1982 – McDonald's Corporation increases its equity in **GADC**: 40% McDonald's Corporation (USA) 60% George T. Yang and family 1998, McDonald's Corporation (USA) increased its effective ownership share in the Philippines (presumably only GADC) to greater than 50%, changing it from an affiliate to majority owned subsidiary. 2001, **McGeorge Food Industries, Inc.** merged into **GADC**, with McDonald's Corp (USA) retaining majority control (> 50%) of GADC.

Table 4 (cont.)
McDonald's Local Organizations in Asia

Country Entry Year	Local Partner	Initial Ownership Structure	Subsequent Changes in Ownership and Management Structure
Malaysia 1982	**Vincent Tan Chee Yioun** Age: 30 worked as bank clerk and insurance salesman, local entrepreneur	Joint Venture: **Golden Arches Restaurants Sdn Bhd** 49% McDonald' Corporation (USA) 51% Vincent Tan Chee Yioun (and others?) Managing Director: Vincent Tan Chee Yioun	1989, Mohamad Shah Abdul Kazir replaces Vincent as Managing Director; Vincent Tan remains as Chairman (and part owner) 1993, ownership of **Golden Arches Restaurants**: 49% McDonald's Corporation (USA) 26% Vincent Tan Chee Yioun 25% Mohamad Shah Abdul Kazir
Taiwan 1984	**David Sun** businessman and president of Quanta Foods Limited	Joint Venture: **McDonald's Restaurants Co. Ltd.** 50% McDonald's Corporation (USA) 50% Quanta Foods Limited (controlled by David Sun, with several partners) Managing Director: David Sun	May 1994, McDonald's Corporation (USA) buys out Quanta Foods share, thus becoming sole owner of **McDonald's Restaurants Co. Ltd.** New Chairman: Bill Rose
Thailand 1985	**Dej Bulsuk** Age: 25 worked in trading company	Joint Venture: **McThai Company Limited** 49% McDonald's Corporation (USA) 51% Dej Bulsuk (with unnamed associates?) President and Managing Director: Dej Bulsuk Local operating licenses (sub-franchises) awarded by McThai Company Limited: Unknown – Chiang Mai (pre-1997)	July 1996 – **McThai Company Ltd** reorganized: Rick Helfand named as general manager Dej Bulsuk as president, managing director 1998, McDonald's Corporation (USA) increased its ownership of **McThai Company Limited** to greater than 50%, changing it from an affiliate to majority owned subsidiary August 1999 – Mike Gomes becomes managing director of **McThai Company Ltd**, replacing Dej Bulsuk who remains as president.

Table 4 (cont.)
McDonald's Local Organizations in Asia

Country Entry Year	Local Partner	Initial Ownership Structure	Subsequent Changes in Ownership and Management Structure
Korea 1988	**Ahn Hyo Young** accountant, local entrepreneur	Joint Venture: **McAhn Industries Limited** established in 1986 to operate in Seoul region 50% McDonald's Corporation (USA) 50% Ahn Hyo Young President: Ahn Hyo Young	February 1991, Ahn Hyo Young dies. Operations continued until July 1994, when seven stores originally opened by McAhn Industries Ltd are bought out by new joint venture, **ShinMc Ltd**.
	Kim Hyung-soo (H.S. Kim) Age: 31 American business graduate and MBA;	Joint Venture: **McKim Limited** established in 1990 to operates in Pusan region 50% McDonald's Corporation (USA) 50% Kim Hyung-soo President: Kim Hyung-soo	1998, McDonald's Corporation (USA) increased its ownership of **McKim Ltd** to greater than 50% (reportedly to 70%), thus changing it from an affiliate to majority-owned subsidiary. Kim Hyung-soo remains as president.
	Shin On-shik (Steve Shin)	Joint Venture: **ShinMc Limited** established in 1994 (?) to operates in Seoul region 50% McDonald's Corporation (USA) 50% Shin On-shik President: Steve Shin On-shik	1998, McDonald's Corporation (USA) increased its ownership of **ShinMc Ltd** to greater than 50% (reportedly to 70%), thus changing it from an affiliate to majority-owned subsidiary. Steve Shin On-shik remains as president.
Indonesia 1991	**Bambang N. Rachmadi** Age: 40 MBA, banker, local entrepreneur	Joint Venture: PT McDonald's Indonesia > 50% PT Ramako Gerbang Mas (controlled by Bambang N. Rachmadi and his family; affiliated company of Ramako Group) < 50% McDonald's Corporation (USA) President and Director: Bambang N. Rachmadi	2000, McDonald's Corporation (USA) increased its ownership of **PT McDonald's Indonesia** to greater than 50%, thus changing it from an affiliate to majority-owned subsidiary. Bambang N. Rachmadi remains as president and director

Local autonomy has clearly been one of the keys to McDonald's success across vastly different countries and cultures. However, experience in the industry has shown that too much independence can lead to problems with quality and uniformity that can eventually damage the brand image. Learning this lesson from its earlier experiences with developmental licensing in Canada and the Caribbean, McDonald's resolved this dilemma by taking a significant equity stake in its international joint ventures. In this way, the company ensures it has sufficient economic incentives to monitor and support the local operations in each new market.

Most of McDonald's joint ventures in Asia have been nearly equal partnerships between McDonald's Corporation (usually through one of its subsidiaries) and its local partner (see Table 4). Occasionally, as in the case of Hong Kong, McDonald's took a majority stake from the beginning; and sometimes, government regulations limited McDonald's investment or ownership share to much less than 50 percent – well below what the company may have preferred, as was perhaps the case in the Philippines. Most often, however, McDonald's initial ownership share in its Asian joint ventures was either 49 or 50 percent. Thus its local operations were affiliates rather than majority-owned subsidiaries for financial reporting purposes in the United States. Expanding into new markets is costly, and it often takes several years to realize a profit. Accounting concerns (i.e., the negative effect on operating results) may therefore have motivated McDonald's decision to avoid majority ownership positions initially. However, there are also other reasons why it may have done so.

Giving its local partners an equal (or majority) stake in the joint venture provided McDonald's with a legitimate claim to be a locally-owned business, a notion it reinforced by putting its partners visibly in charge of the local operations as either managing director or president of the joint venture. This proved to be advantageous when anti-American or nationalist sentiments flared up, as in Thailand and Indonesia during the financial crisis, but it was also helpful in establishing McDonald's as a local brand and promoting a food concept that was alien to the local culture. Certainly no foreigner could have promoted hamburgers as successfully as Den Fujita in Japan, and much of his success is attributable to the obvious fact that he was not a celebrity hired to sell a foreign brand – McDonald's was *his* business and he was clearly Japanese.

This brings us to another simple truth: as equal partners the business, the people in whom McDonald's placed its trust personally had a great deal at stake, and were thus at least as well-motivated as the parent company to see that the business was successful. Moreover, they had an equal voice in decision-making (within the limits of the franchise agreement) and were expected to be actively involved in the day-to-day operations of the business, contributing their unique knowledge and experience of the local market. What McDonald's did not want or need was a silent, hands-off local investor – raising capital was not a problem.

Considering the responsibilities that McDonald's Corporation assigned to its local partners, their careful selection was a matter of paramount importance. Other firms in the fast-food industry usually chose to work with established local companies in the retailing, property development, or food processing industries as a means of facilitating their entry into new Asian markets. McDonald's selected instead individual entrepreneurs as its local partners, and made them the centerpiece of its market entry strategy. This decision was again based on the company's experience, including an unsuccessful corporate joint venture with a major retailer in the Netherlands, from which it determined the benefits of working with properly-motivated individuals would outweigh any potential advantages of working with another corporate entity.[3] Any existing corporate entity would inevitably bring to the partnership a host of preconceived notions, entrenched staff with established habits and operating procedures, and perhaps even an alternative agenda the might put it in conflict with McDonald's. Worse, an established company would probably also have sufficient power, owing to its greater financial resources and local political clout, to one day expropriate the business and leave McDonald's with little or nothing to show for its efforts over the long run. And once the company set its sights on the long-term potential of the Asian markets, choosing individuals as its partners became even more important.

That said, not all countries and markets are alike, and McDonald's was careful to selected partners with different characteristics that suited the particular conditions in each market. In countries with open markets and limited government involvement in business activities, such as Hong Kong, Singapore and Thailand, McDonald's was able to choose relatively unknown young entrepreneurs as its local partners. Where market access or government regulations were of greater concern, as perhaps in Malaysia, Indonesia, or the Philippines, McDonald's partners tended to be older, more recognizable businessmen, or individuals with obvious political connections. Each choice had both advantages and disadvantages, some of which were obviously not recognizable in advance. However, what McDonald's needed most of all from its local partners did not change from country

[3] The one notable exception to this practice, at least in Asia, came with McDonald's entry into the People's Republic of China, where local business conditions and government regulations were not conducive to the development of individual entrepreneurs or their use a McDonald's partners. This appears to be changing, however, as McDonald's has reportedly begun offering single-unit franchises to individuals.)

to country: it wanted competent, hands-on managers whose entrepreneurial spirit and personal drive would make business a success.

In searching for a common set of characteristics or qualifications that McDonald's was looking for in choosing its partners, few real patterns emerge. All of the company's partners in Asia had different backgrounds and experience. Only in the most general ways did they have anything in common. Most had started and run their own businesses, and these remained closely-held private companies (thus reducing any potential conflicts with outside shareholders). Most were experienced in some form of retailing, but none had a significant background in either food service or real estate, two cornerstones of the McDonald's business. (An important lesson McDonald's had learned in the United States was that entrepreneurs from other fields typically do well in McDonald's, while traditional restaurateurs often do not.[4]) Most were still in their thirties when they began working with McDonald's, and thus offered the presumed benefits of both youthful energy and a long-term commitment to the business. Most had also spent time in the United States, having worked or been educated there. Indeed, most had formal business training, and some had even earned an MBA. Yet for each of these generalizations at least one or two exceptions can be found among the individuals McDonald's selected as its partners in Asia. Perhaps the only thing they all shared (aside from gender) was an unusual background as viewed from the perspective of their local business community. All were non-traditionalists in their homeland. They each spoke fluent English, and were uncommonly open to new ideas – and in particular to American ways of doing business. They modeled themselves on the ideal of an American entrepreneur, and were willing to

[4] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, p 429.

commit themselves almost totally to a new business based on an alien food concept that was unproven in the local market.

While McDonald's obviously placed great value on the specific local knowledge and experience its partners brought to each joint venture, it also spent considerable time and money training them in the particulars of its own business. In every case, references were found to the extensive training received by McDonald's Asian partners (or the key members in their organizations). The same commitment applied to local operating crew who were initially sent to other countries to learn the business in established McDonald's restaurants. In addition, McDonald's Corporation frequently assigned its own executives to assist its partners in their managing local operations. Sometimes this was temporary support directed at solving specific problems, but in other cases it reflected McDonald's commitment to protecting its brand image and ensuring successful performance in the local market. Such was the case when John Asahara was assigned the critical tasks of adapting McDonald's standard procedures for implementation in Japan and developing a strong local operations team in the process. Similar support was provided in Thailand, where Rick Helfand was given a three-year assignment as managing director of McThai Company Ltd. under a reorganization necessitated by the challenges of rapid expansion.

Whether this extensive training and support was actually requested by its local partners or was forced on them by a concerned McDonald's Corporation, it seems clear that owning a significant equity stake had made it impossible for the American company to ignore or shortchange its Asian partners. McDonald's is obviously committed to Asia for its long-term potential, which will not be realized if the company fails in its goals of growing and dominating the local fast-food markets. This is evidenced by how the firm structured its businesses in the region. Details on franchising and royalty fees have been difficult to find (and nearly impossible to confirm), but from the limited information that is available it appears these fees generate a relatively small cash flow, as is the case in the United States.[5] Down the road, of course, even small percentage royalty fees will begin to add up as markets grow and total sales increase. However, in the short to medium time frame, as measured against the typical term of the joint-venture agreements which range from 20 to 30 years, most of the cash flow generated from the local operations is simply plowed back into unit expansion. On average the chain has waited nine years for each new international venture to make money, and Asia seems to be no exception.[6] Local company officials in Malaysia have said it took 14 years before operating profits wiped out their accumulated debts. In other words, the wealth created by McDonald's in Asia is largely comprised of long-term investments (mainly real estate) and expected future cash flows. This is fine for an ongoing concern like McDonald's Corporation, but what of its partners? How do they benefit from the wealth they helped to create?

An important component of McDonald's joint venture approach in Asia was an exit strategy – not for the company, but rather for its local partners. As an equity partner from beginning, McDonald's Corporation had almost complete access to information on how the business was developed and managed in each country, and over time it was able to develop an intimate understanding of local market conditions. This would not have been the case under a developmental licensing approach (or even in direct franchising).

[5] As mentioned earlier in this paper, the royalty fee paid by McDonald's Japan was initially 1.0 percent of sales, which was only increased to 2.5 percent with the renewal of the 30-year franchise agreement in 2001. In the Philippines, the royalty fee was estimated to be near 2.0 percent of sales, while the same source says that in Thailand the royalty was set at 5.0 percent of sales (though neither of these has been confirmed). It was also reported that the Thai joint venture pays a one-time franchise fee each time a new unit is opened.
[6] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, p 444.

Having a major equity stake bought McDonald's a seat in the boardroom, and with it a better ability to monitor and evaluate the local operations. In this way, the firm might eventually be prepared to buy out its partner and run the business as a wholly-owned subsidiary. This had potential benefits not only for McDonald's, but also for its local partners who might otherwise be unable to convert their wealth into cash to be spent in their retirement (or transferred to others). An example of this occurred in April 1995, when McDonald's exercised its option, at the end of a 20-year franchise agreement, to buy out Daniel Ng's 33 percent share in Hong Kong. Although Ng remained involved as chairman of McDonald's Restaurants (Hong Kong) Limited and assisted McDonald's in developing the China market, he did so as an employee with no long-term commitment from the company. Of course, his pockets were already filled with cash from the buyout.

In one way, McDonald's held all the cards in this game, as the terms of its joint venture and licensing agreements made it clear that the franchising and operating rights to McDonald's in a country were not transferable, and were dependent on the continued involvement of the local partner in the business. Thus neither Den Fujita in Japan nor George Yang in the Philippines was able simply to transfer ownership of his franchise rights to his son, even though they had been involved in the McDonald's business and owned shares in the local company. In Japan, an answer to the succession problem was found in the conversion of the local company shares to public ownership; McDonald's Corporation retained 50 percent of the stock (it had previously owned 55 percent), while Den Fujita and his son Gen Fuijita both reduced their personal stakes, but remained as major shareholders and directors of the company. In the Philippines, George Yang had previously noted if his children were to take over the business, they would 'have to prove themselves capable'. When the term of his 20-year term joint venture agreement was over (coincidentally, not long after legal restrictions against foreign ownership of retail operations were removed), McDonald's consolidated the Philippine operations into a single majority-owned subsidiary, and named Kenneth S. Yang as its executive vice president. In these ways McDonald's showed respect for the traditions of Asian family businesses without jeopardizing its own interests by permitting unproven offspring a major stake in the local operations by means of a simple windfall inheritance.

A different kind of succession problem arose in South Korea, when McDonald's first partner died in February 1991, less than three years after opening his inaugural store. Ahn Hyo Young's family situation at the time is not known, but it appears there was no one suitable to take over the business. A new joint venture partnership was later formed, and in July 1994 it bought out the seven restaurants Ahn had originally opened.

While a partner's death is something one may anticipate, it is not usually planned for in advance. Such is not the case, however, when a falling out occurs between partners in a joint venture. Troubles in a partnership usually become evident over time, giving the parties a chance to plan a rational course of action that one hopes will resolve differences in manner that is acceptable to everyone involved. However, McDonald's has not been immune to the nastier turns such conflicts can take. In 1982, the company was forced to go to court to oust its initial franchisee in France, and as a result it virtually had to start over in that country.[7]

Nothing quite so dramatic has yet occurred in Asia, but there have been changes in two countries that appear to be possible results of disagreements between McDonald's and its partners. The first occurred when Vincent Tan, McDonald's joint venture partner

[7] Love, John F., *McDonald's: Behind the Arches*, Revised Edition, Bantam Books, New York, 1995, p 463.

in Malaysia, resigned as managing director of the local company in 1989. Not long after he started the business, just seven years before, Tan had became involved in several other ventures, and was clearly not able to devote enough time to day-to-day operations of his McDonald's business. He was replaced as managing director by another Malaysian who was later confirmed to be an equity partner in the business (when he actually acquired his 25 percent of the local company was not determined, but Tan retained a 26 percent share along with the title of chairman). It may be the new managing director had been involved with McDonald's from the very beginning, perhaps even acting as the hands-on manager, but this only suggests a best case scenario in which McDonald's Corporation wanted a local manager who at least *appeared to be* dedicated solely to running the joint venture. In the worst case scenario, the McDonald's business may have been suffering under an absentee manager. Another change occurred in Taiwan, where McDonald's Corporation bought out its joint-venture partner after just 10 years. Whether the parting was mutually desired or the result of some disagreement is not known, but not long after McDonald's began investing heavily in a rapid expansion of its Taiwan chain while its former partner and his associates opened several other food service businesses locally and in China.

From all this it is clear that McDonald's understood and respected the potential difficulties of extending its business into Asia. The company recognized that it needed to acquire the local knowledge, experience, and energies of an indigenous entrepreneur – at least in the early years of the business until it learned the new market. (It is this need for specific local knowledge and experience that probably explains the few cases where units have been sub-franchised to individuals in Southeast Asia. All of these franchised stores appear to be located in more remote parts of the country or in small isolated urban areas.)

Assuming it could find appropriate individuals who were willing to dedicate themselves to the McDonald's business, these would always be preferable as partners to any existing corporate entity. Finally, McDonald's knew for its partners to be properly motivated, they would require a significant equity stake – with long-term rewards based on realizing the upside potential of the business – while at the same time the company itself needed to have a significant capital investment at risk to provide it with appropriate incentives to support and grow the business, at least until it reached the point where the cash flow from royalty fees was greater than the cost of providing ongoing support. Not surprisingly, this was basically the same lesson McDonald's had learned in the United States. It was also a lesson many other fast-food chains ignored to their later regret as they too ventured overseas.

Suppliers Networks in Asia

In preparing to enter each new international market, McDonald's faced a problem of critical importance: how to organize its supply chain. By the early 1970s the company had developed throughout the United States a network of suppliers that were experienced in meeting its particular requirements and high quality standards. However, almost none of these had established overseas operations, much less ones suited to McDonald's needs. The company could always import its requirements from America, but that was a costly and complicated option even in the short run. In the long term, it would become critical to establish local suppliers to reduce costs and permit greater flexibility in pricing. It was also important for suppliers to understand and respond to McDonald's particular needs in each local market, something no long-distance exporter could even hope to do.

Developing local suppliers in Canada posed little problem; even in Europe there were many companies who could produce the baked good, meat, cheese, potatoes, and fresh produce that McDonald's required, some of these willing to meet its requirements and work cooperatively within the McDonald's System. Asia was a completely different situation. Beef, dairy products, potatoes, and even baked goods were not so commonly available; developing local suppliers thus presented a much greater challenge, which may partly explain why the company chose initially to enter the markets it did. In the case of Japan, Den Fujita was an experienced importer who convinced McDonald's that Japanese consumers would be willing to pay sufficiently high prices to cover the cost of imported food requirements. Hong Kong and Singapore, although less affluent, had the advantage of open trade policies with no local agricultural industries to protect. By starting first in these markets, McDonald's was able to establish some reasonable scale to its operations in Asia, which made it easier to encourage new suppliers to invest in production facilities to meet its needs in the region.

McDonald's entry into several Asian markets, including the Philippines, Taiwan, and South Korea, was reportedly delayed for several years because it had to comply with various government import restrictions and local-content requirements. In some cases it was able to find suitable suppliers among the local affiliates of American food companies such as Swifts, Kraft, Carnation, and Griffith in the Philippines, and of course Coca-Cola was nearly everywhere, but in most cases McDonald's was forced to deal with new local suppliers. Potatoes seemed to present a universal concern, perhaps because transporting fresh potatoes from America resulted in too many quality problems. McDonald's worked with farmers in the Philippines, Taiwan, Thailand, and South Korea in attempts to grow suitable spuds locally for its fries. At least in Southeast Asia, all these experiments failed due to quality concerns (the problem of 'soggy fries') and the company soon switched to importing frozen french fries from the United States (a fact confirmed when the currency crisis caused import costs to soar, prompting the company to substitute local rice for fries some of in its value meals).

As the McDonald's chain grew in each market, it became possible to encourage suppliers to invest in same kind of exclusive production and distribution facilities that had made the McDonald's System so efficient in the United States. Perhaps the most important of these new suppliers were the meat processing companies that made the beef and pork patties, chicken and fish portions, breakfast sausage patties, chicken nuggets, and even frozen breaded chicken parts. Not surprisingly, it was two of McDonald's established suppliers from the United States made such investments. Keystone Foods formed local joint ventures in Malaysia (MacFood Services Sdn Bhd), Thailand (McKey Food Services), and China (McKey), while OSI Industries did the same in the Philippines (GenOSI), Taiwan (K&K Foods), China (HUSI Foods and Coronet Foods), Indonesia (Japfa-OSI), and India (Vista Foods and Taloja). The chicken (and perhaps also pork) used in these facilities was locally procured, while the beef and fish were imported from Australia and New Zealand. Nevertheless, the value added by these plants significantly increased McDonald's local content and resulted in a more reliable and flexible supply chain. These suppliers were also instrumental in the development of new products and flavors specifically suited to the local each market. With factories in several different countries, McDonald's had not only solved its local supply problems but in the process created a network of regional suppliers that could backstop one another in the event of short-term capacity or quality problems.

Another benefit of having an extensive regional supply network became evident when the currency crisis hit Asia in 1997. Almost immediately McDonald's operations in Singapore and Hong Kong stopped importing chicken products from the United States and switched to lower cost products from McKey Food Services in Thailand. McKey later began sending products to South Korea and Japan. This helped McDonald's reduce operating costs in those markets, and it gave the firm an important public relations boost in Thailand, where it made a credible claim that McDonald's was actually a net exporter. Similar situations occurred in Malaysia and Indonesia (and perhaps elsewhere), as some McDonald's suppliers suddenly became competitive exporters to operations outside the region. These local suppliers also helped ease the effects of the crisis by accepting price cuts, knowing their loyalty to the McDonald's System would be remembered (in some cases it already had been, in the form of increased export business). Where intra-regional supply agreements existed before the crisis, there was little or no disruption, since most of the Asian currencies suffered similar devaluations. Still, almost everywhere in Asia McDonald's costs increased significantly in late 1997, due mainly to imported beef and french fries. However, had the crisis struck just a few years earlier, before McDonald's had established such an extensive supply network, the impact on its operations would have been much more severe.

The ultimate goals of McDonald's efforts to build this supply network in Asia are greater efficiency, higher quality, and lower operating costs. Already, the realization of these goals (so far as they have been achieved) has provided the company with a clear competitive advantage in several of its Asian markets. As for the others, one may rest assured that McDonald's will continue to develop this network and exploit any synergies that may exist consistent with the principles of the McDonald's System.

Evolution and the Patterns of Change

By the time McDonald's entered Indonesia in early 1991, the company already had two decades of experience in Asia. In that period it had established 1000 operating units in a dozen different countries and territories throughout the Asia/Pacific region, not counting those in Australia and New Zealand. Worldwide, McDonald's was present in more than 50 countries outside North American. Obviously, the firm had learned some things along the way about how to work in different cultures, systems, and business environments. It is therefore all the more remarkable that the chain's development followed such similar patterns in each new market it entered.

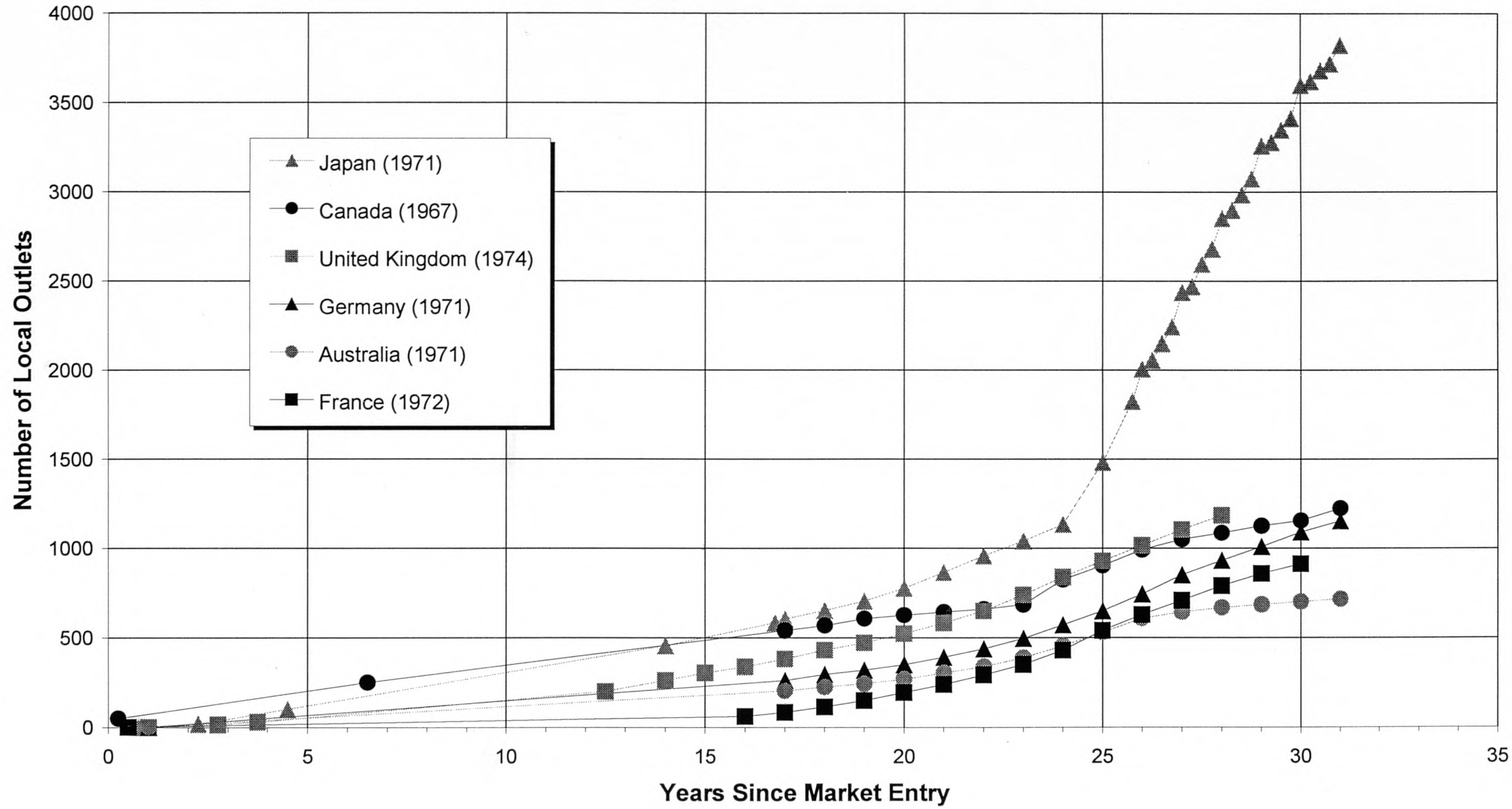
Leaving aside China, which presented McDonald's with an entirely different set of challenges, many of them unique, the company has remained fairly consistent in its business strategies and practices throughout Asia. This is perhaps most obvious in its decision to form nearly equal equity partnerships (joint venture companies) with local entrepreneurs in whom the company placed great trust to develop and run the business. Less obvious is the fact that McDonald's followed remarkably similar marketing and development strategies in each Asian country it entered.

Beginning with its entry into Japan, McDonald's positioned itself as a more upscale dining experience than in the United States – at least initially. As Den Fujita recognized, it was the novelty of a uniquely American food and service concept that appealed to Japanese consumers, who were not only willing to pay a premium price to enjoy McDonald's hamburgers, but apparently expected to do so. In keeping with this image, the early McDonald's restaurants in Japan were built in prime urban locations. Only much later, after the brand had been established, did McDonald's outlets begin appearing in the suburbs and in non-traditional locations like schools and factories.

Nowhere else in Asia was premium pricing taken to the same extreme as it was in Japan. However, it remained a simple fact that the people most likely to try McDonald's were those with money and an exposure to (and perhaps affinity for) American culture. In other words, the target demographic for McDonald's in Asia was wealthy urbanites. Winning over these people was critical to building the brand's image and eventually growing the market in parallel with the rapidly expanding middle class, who were mainly urban. As a result, the earliest McDonald's restaurants throughout Asia were located in prestigious and expensive sites in the major urban centers. This obviously added to the already high costs of establishing operations in a new country. With no economies of scale and a necessarily heavy reliance on imported materials and supplies, the ability to charge premium prices was one of the critical factors determining the potential growth rate of the chain. Others factors included property prices and volatility in the real estate markets, and the local partner's ability to raise additional capital for investment.

Japan itself did not become a truly exceptional market for McDonald's until the mid 1990s, when the rate of unit expansion rapidly increased, due mainly to a shift in emphasis to the satellite store concept. As shown in Figure 27, the rate of McDonald's unit growth in Japan over its first twenty years was not much greater than in other 'big six' international markets, especially considering Japan's larger population. However, beginning in 1994 McDonald's Japan implemented a new strategy called 'aggressive

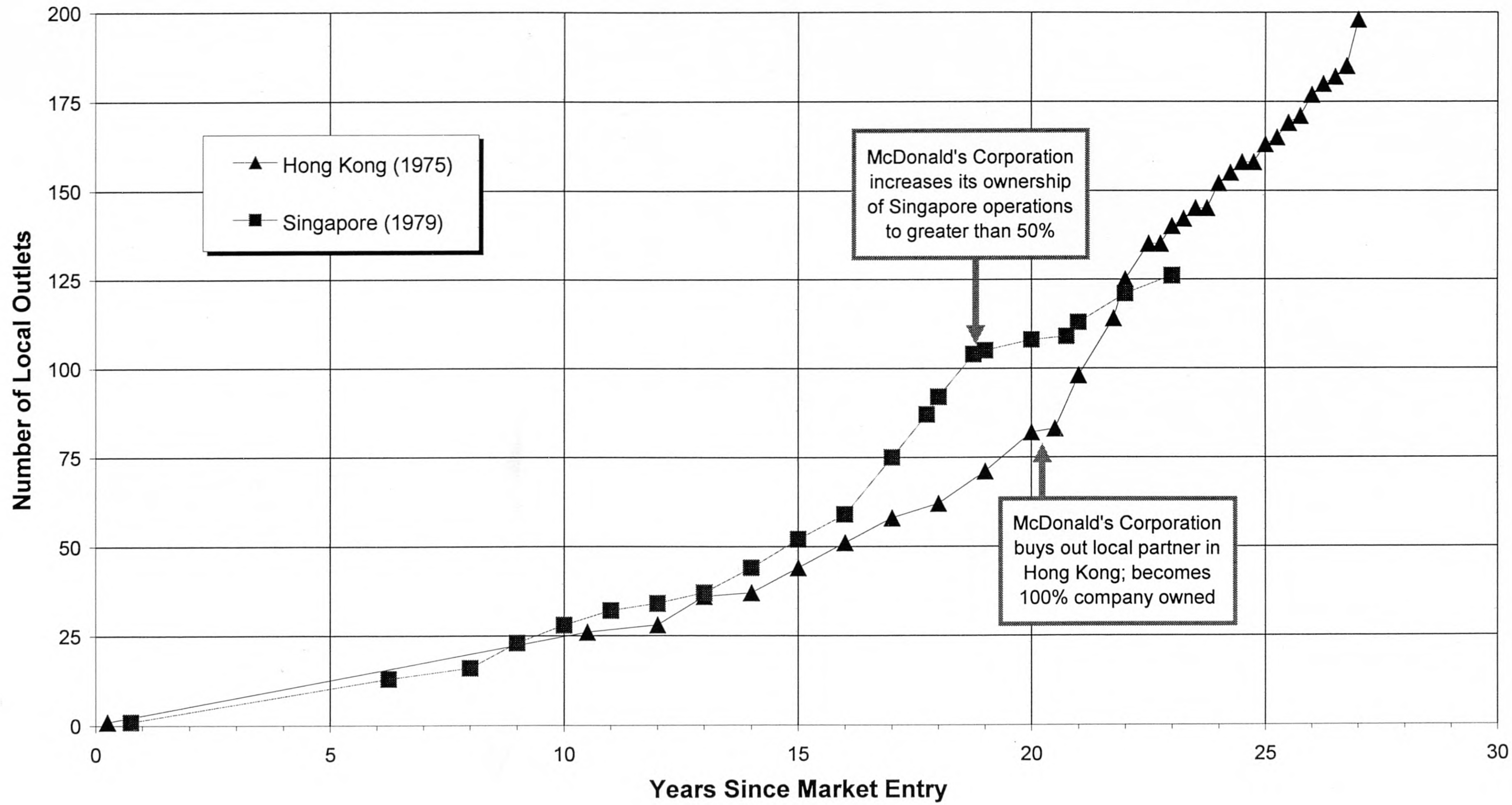
Figure 27
McDonald's Rate of Growth in the 'Big Six' International Markets



restructuring' that involved both significant price reductions and greatly increasing the number of its sales outlets through the use of satellite stores, which are significantly less expensive to build than traditional stores. Over the eight years from 1994 to 2001, nearly two thirds of the 2782 outlets added to the McDonald's chain in Japan were satellite stores (as shown in Figure 5). Although the ultimate result of 'aggressive restructuring' on profitability remains somewhat dubious (its real purpose seems more to increase market share), the strategy of combing lower prices with rapid unit expansion would clearly have been impossible with a lower cost option for store real estate.

The relationship between pricing policy, property costs, and capital available for investment is also illustrated by comparing McDonald's development in other countries. First consider Hong Kong and Singapore, which are similar markets in many ways. Both have small, concentrated urban populations with high per capita incomes, both import most of their food requirements, and both are among the world's most open markets. As shown in Figure 28, the rate of unit growth in each place was similar over the first ten to fifteen years of McDonald's presence, after which the chain began to grow more rapidly in Singapore. This seems a bit unusual, given the fact Singapore's population was little more than half that of Hong Kong. Although property prices may have differed between the two markets, especially considering that McDonald's entered Singapore nearly five years later than in Hong Kong, other factors may be even more important in explaining the difference in growth rates. Hong Kong was unusual in that McDonald's local partner promoted a low-price value concept from the start. As a result of lower margins, higher traffic volumes were required to cover fixed costs in each store and unit expansion thus proceeded more slowly. Perhaps the Singapore market was not so cost conscious, and

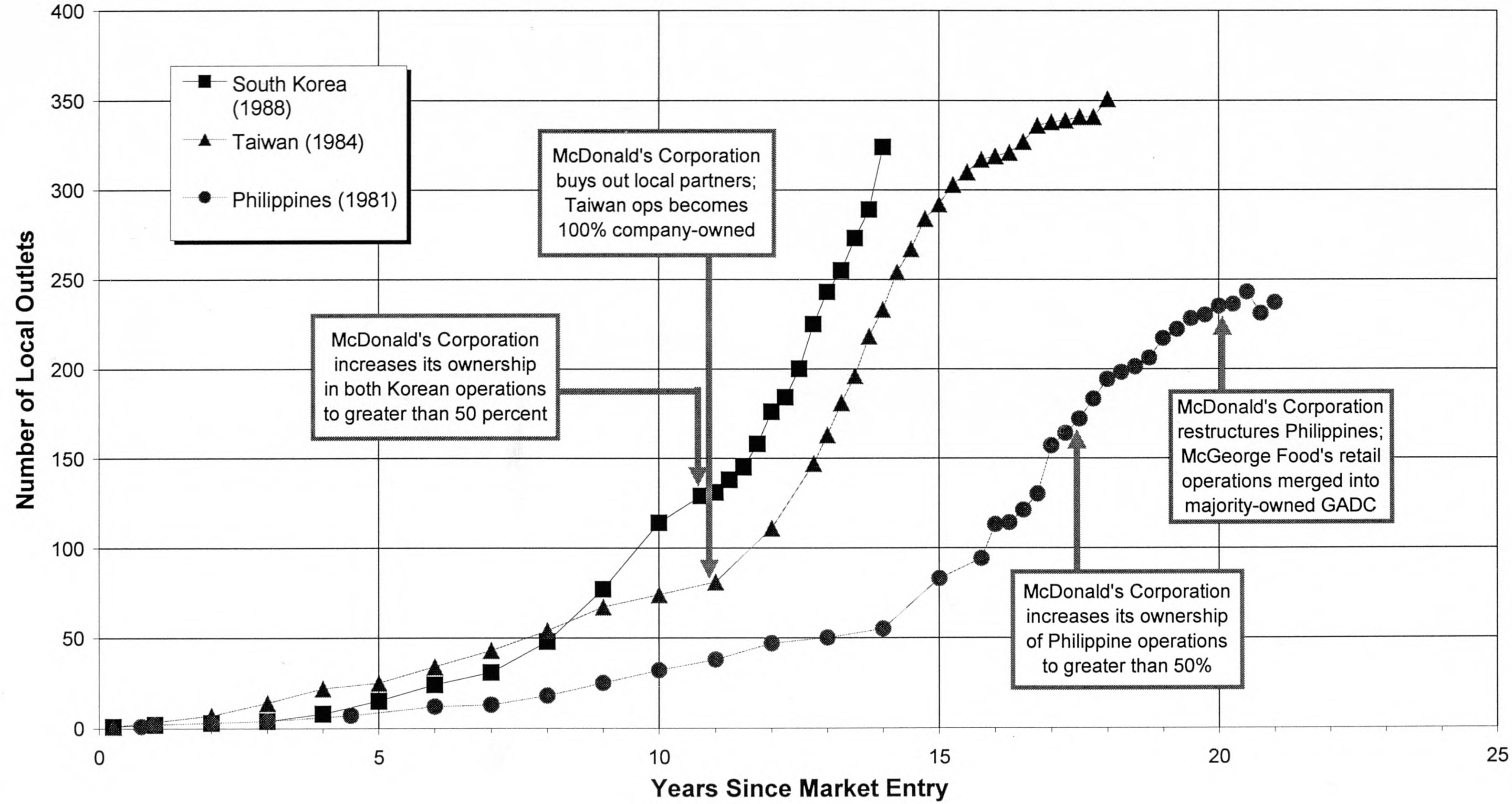
Figure 28
McDonald's Rate of Growth in Hong Kong and Singapore



McDonald's was able to expand more rapidly there because of higher operating margins derived from higher prices. However, there is another possibility to consider. The rate of growth in Hong Kong may have been even lower had McDonald's owned less than two-thirds of the local joint venture. The fact that unit growth accelerated after McDonald's bought out its local partner in April 1995 suggests that its expansion was limited partly by the local partner's inability (or unwillingness) to contribute additional capital. This effect was later observed in Singapore, where a reduction in McDonald's growth rate coincided with the onset of the Asian financial crisis in late 1997. In the circumstances, a lower growth rate by itself is not surprising and could simply be a reaction to a slowdown in the marker. However, McDonald's increased its ownership of the local joint venture in 1997, thereby converting it from an affiliate to majority-owned subsidiary in the process. This suggests that the local partner had suffered a bit of a financial crisis himself.

A similar analysis can be applied to McDonald's unit growth elsewhere in Asia. Figure 29 shows unit growth over time in three of McDonald's biggest markets in Asia: South Korea, Taiwan, and the Philippines. Taiwan is perhaps the most straight-forward example, as the unit growth there exhibits some features of a classical 'S-shaped' curve. However, the flatness of the curve over the first 11 years shows that percentage growth rates were actually declining before McDonald's buyout of its local partner in May 1994. After that, the chain experienced very rapid growth for almost five years, during which time McDonald's established a dominant position in the local fast-food market. Slower growth in recent years (the tail end of the 'S-shaped' curve) probably reflects a temporary downturn in the local economy more than actual saturation of the market, although that is perhaps also beginning to happen.

Figure 29
McDonald's Rate of Growth in Korea, Taiwan and Philippines

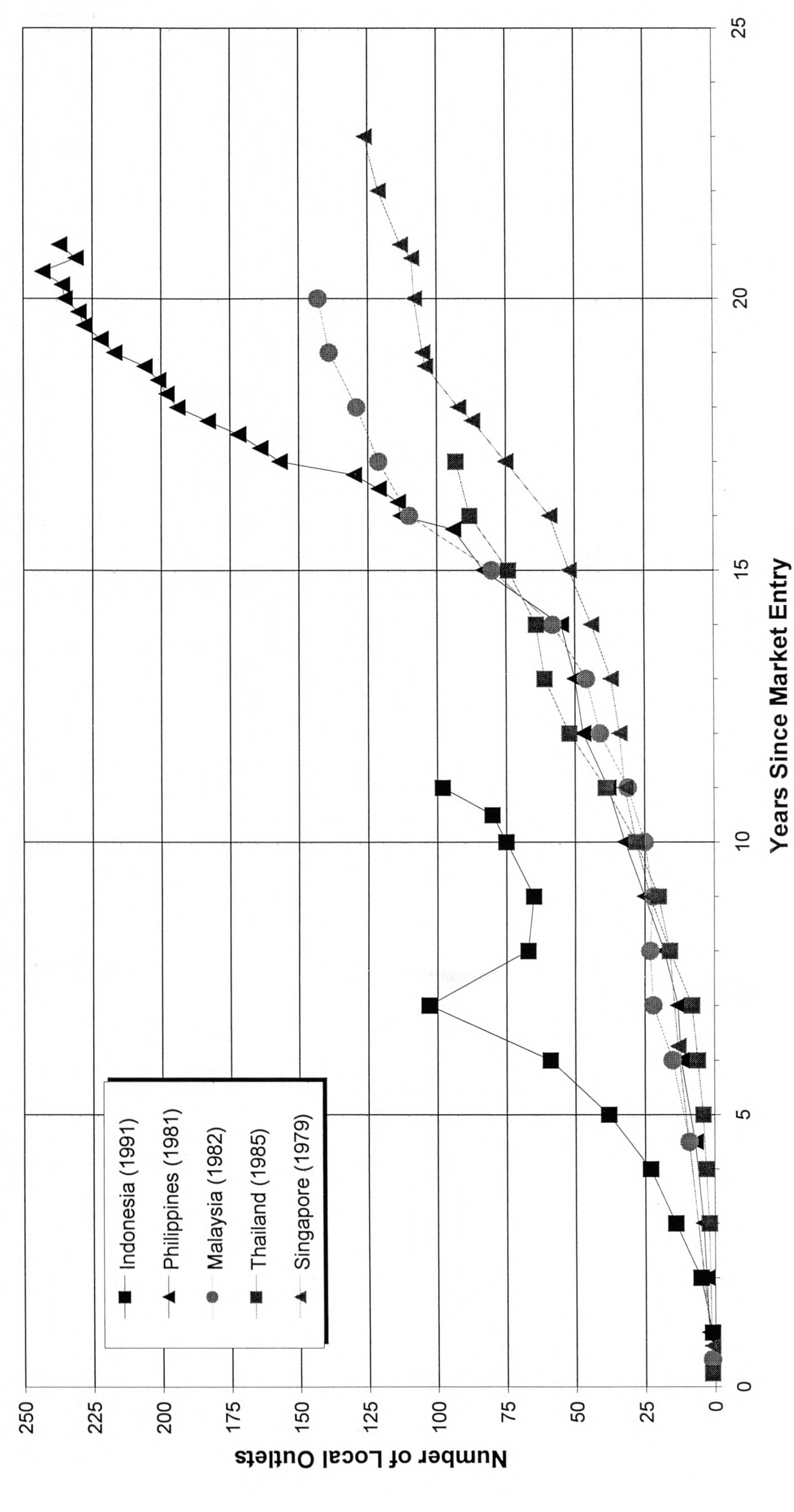


In South Korea, there is not yet any evidence of slower growth, and such may not occur for several more years considering its population is more than twice that of Taiwan. What it interesting about South Korea is the fact that the company got off to such a slow start (see Figure 29), and this after its initial entry had been delayed for several years by various government restrictions. High real estate prices and undercapitalization of the original joint venture have been blamed for the slower-than-planned early growth rates. The death of its local partner in early 1991 also hurt, as McDonald's had to start over in Seoul with a new joint venture partner. In the mid 1990s, the unit growth rates began to accelerate. Perhaps this was due to the fact the company now had two joint ventures (and therefore two sources of local capital) operating in different parts of the country. As in the case of Singapore, however, the local partners became unable to sustain rapid growth when the Asian financial crisis hit in 1997, and this resulted in McDonald's increasing its ownership from 50 to 70 percent in both local companies during 1998. After that, the chain began growing even faster than before, and over the last three years (1999 to 2001) has expanded at an average annual rate of more than 35 percent.

While the Philippines has a much larger population than either Taiwan or South Korea, it is also less wealthy and should perhaps not be expected to exhibit the same kind of growth rates. And as in South Korea, there were extenuating circumstances that help to explain the early slow growth in the Philippines. However, little or no improvement was exhibited during the boom years of the early 1990s, and it was not until 1995 that the unit growth finally began to pick up (see Figure 29). Part of the explanation for this must lie in the inability or unwillingness of McDonald's local partner to invest more heavily in the business. McDonald's Corporation itself was restricted by law to a minority stake in the Philippines, and it was excluded from any direct control over the retail operations. It is not clear how or why the growth rates suddenly began to increase in 1995, but it seems possible that McDonald's had found a way around the government restrictions. At least that appears to have been the case three years later when, in the wake of the Asian crisis, McDonald's committed a huge sum (USD 55 million) to expansion and later reported an increase in its ownership in the Philippines that occurred in 1998. It now appears that the parent company may have actually extended loans to the local joint venture to facilitate expansion that went beyond what its local partner could support. These loans, which did not immediately affect legal ownership of the local operations, were then converted into equity a few years later, after a change in the law permitted McDonald's Corporation to own up to 100 percent of its local operations in the Philippines. McDonald's completed a restructuring of its business in the Philippines in 2001, and now has majority ownership over all aspects of the local business. If previous behavior elsewhere in Asia is a guide, McDonald's can be expected to resume aggressive expansion in the Philippines with the goal of reducing the gap between itself and the market-leader, Jollibee.

The impact on unit growth of McDonald's increased equity investments in the Philippines is even more apparent when compared to other ASEAN countries, as shown in Figure 30. Given its larger population with an affinity for things American (including its dietary habits), the Philippines might logically be expected to be McDonald's biggest market in ASEAN. And so it is, at least in terms of the number of outlets. But what is truly remarkable is how long it took for McDonald's development in the Philippines to outpace its growth in the other ASEAN countries, not to mention its low market share. The impact of a strong local competitor (Jollibee) helps to explain these results, but the

Figure 30
McDonald's Rate of Growth in ASEAN Countries



same might be said of KFC's presence in Malaysia, Indonesia, and Thailand, where the local populations have a demonstrated preference for chicken over burgers (and where McDonald's sell more bird than beef). McDonald's started slowly in almost every new market it entered, yet its growth usually picked up within a few years and the company has typically responded to competition by increasing its rate of expansion, as in Japan and South Korea. That it did neither of these for so long in the Philippines seems a bit mysterious, and may be attributable to its unique organization structure in that country.

If McDonald's Philippines operation was a laggard, then its Indonesian operation was sprinter with marathon ambitions. Only in Indonesia did McDonald's initial growth rates differ significantly from those in the other ASEAN countries (see Figure 30). This fast-paced beginning proved to be unsustainable in the wake of the 1997 currency crisis. How McDonald's local partner in Indonesia was able to afford the investments required for such rapid growth soon became evident. Like others in the region, he had succumbed to deals denominated in foreign currencies, and this became his undoing. Unable to make the required U.S. Dollar rental payments with the Indonesian Rupiah it earned in its local restaurants, McDonald's was forced to close a third of its outlets in 1998. By the end of the next year, as its local partner was defaulting on loans and facing possible bankruptcy claims, McDonald's Corporation increased its ownership in Indonesia to greater than 50 percent, and the unit growth almost immediately resumed.

Why McDonald's attempted such a rapid initial expansion in Indonesia has not been confirmed. Of all its Asian markets, only Japan and China had a greater number of McDonald's outlets in operation than Indonesia within the first five years; and the same was still true after seven years when crisis hit. A desire to achieve greater economies of scale is one possible answer, but the fact that McDonald's units were not geographically concentrated in Indonesia seems to weaken this theory. At one point in early 2001 there were 77 McDonald's outlets spread across 25 cities in Indonesia, and only 36 of these units were in Jabotabek (the main metropolitan region of West Java comprising Jakarta, Bogor, Tangerang, and Bekasi). Perhaps the only real explanation is that in Indonesia McDonald's had a partner who was both willing and (apparently) able to support more rapid growth.

Another pattern that emerged more clearly in the aftermath of the 1997 crisis is McDonald's tendency to shift away from its initial brand position as a novel and fairly upscale dining experience toward greater price competition and product differentiation. McDonald's initially stuck with its standard American menu items whenever it entered a new Asian market. Only after several years operating in a market did the company begin to introduce new products that were perhaps better suited to local tastes. This made sense because people already knew that McDonald's was famous for hamburgers in America, and it was this well-established brand image that the firm was trying to sell. Further, no one could predict what new products might be successfully sold by McDonald's, or how these would do in comparison to its standard fare. It also took time to develop a network of local and regional suppliers to support new product research, development, and market testing. Meanwhile, the simplest way to begin operations in a country was to stick with what everyone already knew best – the standard menu – and simply import any special food items from existing suppliers as was necessary to accomplish that. This standard menu strategy generally worked well, though some have argued that McDonald's should have moved faster to introduce new products in South Korea and the Philippines, where local competitors Lotteria and Jollibee gained big market leads with popular menu items based on local tastes. Nevertheless, as McDonald's novelty began to wear off, and the number of competing fast-food concepts increased, new products started to find their way onto its local menus, including McCrispy fried chicken which was a big hit in Southeast Asia.

As each local market matured, McDonald's also began to run special promotions. Initially, these were in the form of giveaways, such as the incredibly popular 'hello kitty' dolls that became notorious for promoting long queues and occasionally riotous behavior among McDonald's customers in Singapore and Hong Kong. Over time, and especially in the more competitive markets, McDonald's began to run special price promotions and even made permanent price cuts. Japan was the first in Asia to see competitive pricing tactics used by McDonald's. Beginning in 1994, the company began running month-long reduced-price promotions, the success of which eventually led the company to implement its first round of permanent price cuts. McDonald's had learned about customer demand in Japan and was becoming more sensitive to price-volume tradeoffs in its business. In subsequent years, the local company continued to run special promotions, usually during the worst of economic times, and later made another round of permanent price cuts that together resulted in the departure of several competitors from the local market. Having an apparent cost advantage over other local chains, McDonald's Japan seems prepared to continue with this price competition strategy indefinitely.

Similar price competition strategies have been introduced elsewhere in Asia, but these were mainly in response to the consequences of the 1997 crisis and the more recent economic slowdown caused by declining exports from Asia to the United States. South

Korea, Indonesia, Thailand, Malaysia, and the Philippines had all seen McDonald's cut its prices of standard menu items and introduce new products that can be offered more cheaply because of their higher local content. Chicken, eggs, and rice have become the new menu standards more out of economic necessity rather than a desire to cater to local palates. Value meals – special sets consisting of a sandwich and drink (and perhaps with a side of rice instead of french fries) – also became commonplace. As a result of price wars that ensued following the 1997 crisis, McDonald's and other fast food leaders in South Korea and most of the Southeast Asia markets have now become accustomed to competing on price – perhaps before any of them were prepared to do so.

Whether a shift to price competition would have inevitably occurred in these markets is likely not even a question in the minds of the McDonald's executives who continued to expand their chain and supplier networks in Asia throughout the difficult economic times since 1997. The real question for McDonald's was how to gain the necessary economies of scale to win a price war without simultaneously diluting the financial interests, and therefore incentives, of their local partners. If price competition was seen as inevitable in Asia, then it fits neatly into the exit strategy for McDonald's partners (as discussed in the previously subsection).

With few exceptions, McDonald's has been among the first fast-food companies to enter each of the Asian markets. Where it did this, it has been able to establish and maintain a leadership position in the market and thus delay the inevitable onset of price competition. It was not until the mid 1990s, more than 20 years after its market entry, that McDonald's Japan began an aggressive pricing strategy. By that time the company had already established the largest chain in the country and developed a highly efficient operating system and network of suppliers. In Singapore and Hong Kong, which have no local agricultural base and few import restrictions, McDonald's did not face a major cost disadvantage relative to local firms, while the strength of its overseas supplier networks give it major advantage over other foreign firms. This allowed the firm to develop its chain in concert with the growing market. It was much only later, as the market began to be saturated with different fast food concepts that promotions and price reductions became more important, but by then McDonald's held a commanding share of large market and enjoyed the benefits commensurate with its economies of scale. This was also about the time that its local partners were prepared to leave the business, and reap the rewards of their earlier equity investments. In the few places where McDonald's made a late entry, as in South Korea, or fell behind others in the local market, as in the Philippines, the company faced the difficult challenge of needing to rapidly expand its chain while simultaneously competing on price (if only to induce trials). In such cases organic growth is usually impossible, and the need for additional capital may result in a conflict between the partners if one party is unable or unwilling to match investments of the other. One of two things may then happen. Either the local partner is forced to suffer a significant reduction (dilution) of his equity stake, with a concomitant risk of reducing his personal long-term incentives, or the chain fails to expand as a rate necessary to keep pace with or make gains in the growing market.

Thailand and Indonesia seem to be two places where unforeseen circumstances (the 1997 crisis) pushed McDonald's into price competition at an earlier stage than it desired. Both markets still had tremendous growth potential that made continuing with expansion highly desirable, but reduced operating margins made this impossible without unilateral investments by McDonald's that diluted the local partners ownership share. No one can accurately predict the point at which market saturation will be reached (if indeed there is such a point), but the local partner with a 20 or 25 year joint venture agreement has a potential to see the chain approach this point, at which his equity investment will have its maximum valuation (based on expected future cash flows). What a local partner would not want is to see his ownership share reduced well before this occurs. Thus it is in both parties advantage to avoid price competition for as long as possible, but especially when the market is still growing and the incentives to expand the chain remain strong.

The Future

In recent years several analysts have been critical of McDonald's Corporation's aggressive international expansion. Some have simply argued that continued massive investments are risky and hurt current earnings, while others seem to believe than many overseas markets, like those in North America, are already approaching saturation. As might be expected, McDonald's Japan has been a favorite example of those who believe the company is being overly aggressive, and there is certainly some evidence to support such a claim in the case of Japan. McDonald's operations in Hong Kong, Singapore and Taiwan may also be close to having run the course, and McDonald's investments in the latter two of these markets has indeed slowed in recent years. But what of other, bigger markets in Asia? What future does McDonald's have in these?

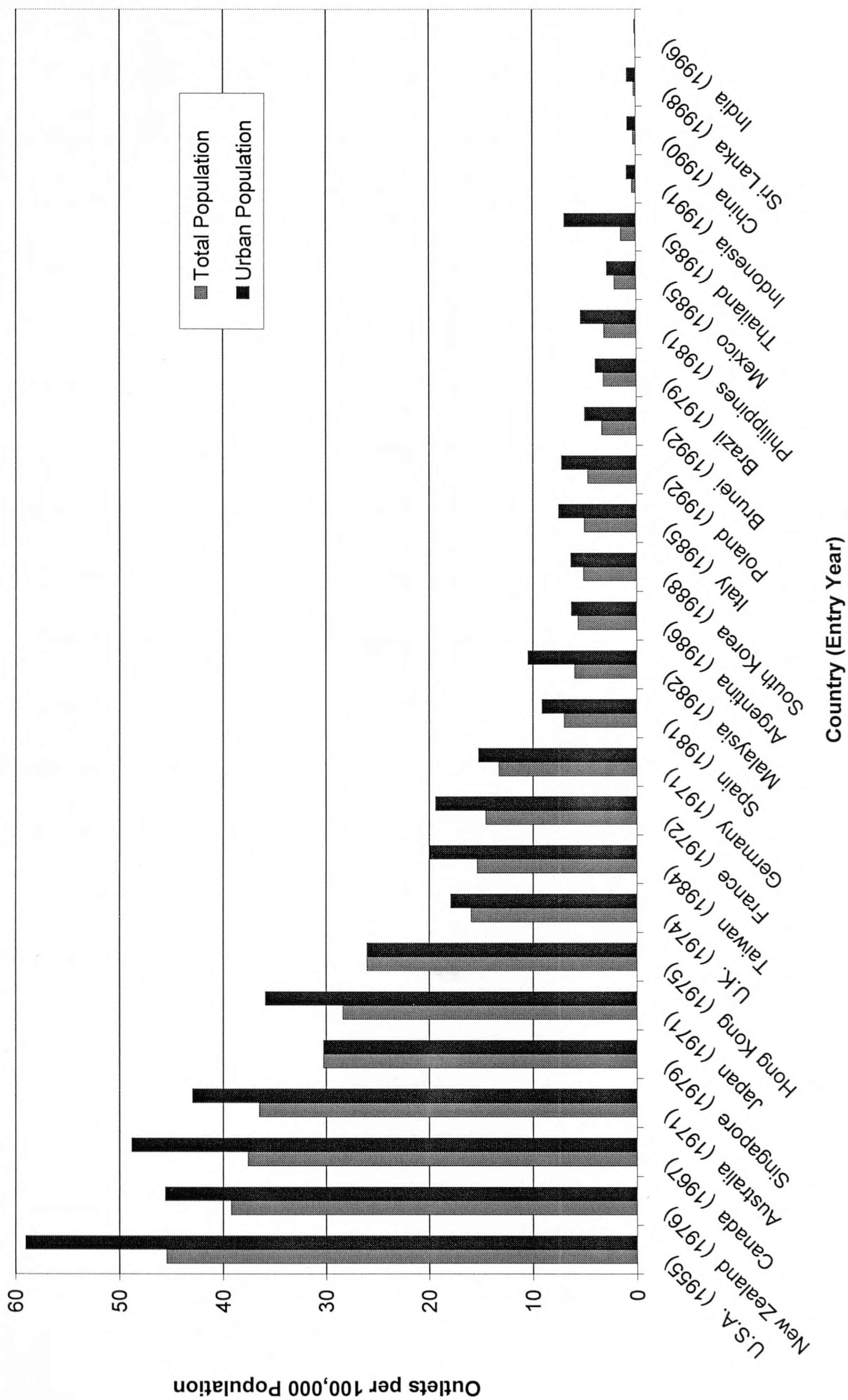
Of course, the greatest potential market is the Peoples' Republic of China, and suffice it to say that with 430 outlets opened there in the last ten years McDonald's has already made considerable progress. One might also think of India, and its large middle class, as another market with huge potential. Since entering in India in 1996 McDonald's has grown slowly, but steadily to a total of 34 outlets concentrated in Delhi and Mumbai. While the concept has been slower to catch on there, one can expect that McDonald's will one day have a much larger presence in India. Other new markets also beckon, such as Vietnam, where McDonald's has quietly taken steps in preparation for its eventual entry by working with a local company, Vissan (Vietnam), that plans to import breeding stock and raise beef cattle locally to supply McDonald's.[8] In the context of this study, however, a more relevant question is how much longer McDonald's should continue to expand its existing operations in Asia.

The idea of market saturation, or at least the notion of some cap or upper limit on retail sales, is a somewhat dubious concept, since that markets are continually evolving as new products are developed, customer preferences change, income distributions shift, and economic development results in greater wealth and more disposable income. In the case of the fast-food industry, which initially has the greatest appeal for children (a fact not missed by McDonald's marketing message), generational changes also play a role, along with changing lifestyles and increased urbanization. In the simplest terms, one could simply consider total population as a basis for determining future market potential. To refine this approach, we might further limit ourselves to considering only the urban population, since fast-food companies have so far restricted themselves to urban areas (and this seems unlikely to change much in the near future, at least in Asia).

Figure 31 shows the current level of market saturation by McDonald's in various markets around the world in terms of the number of retail outlets per 100,000 population, based on both the total and urban population in each market. This data seems to confirm

[8] Anonymous, "McDonald's Beefs up for New Launch", *Vietnam Investment Review*, Volume 286, 7 April 1997, page 3.

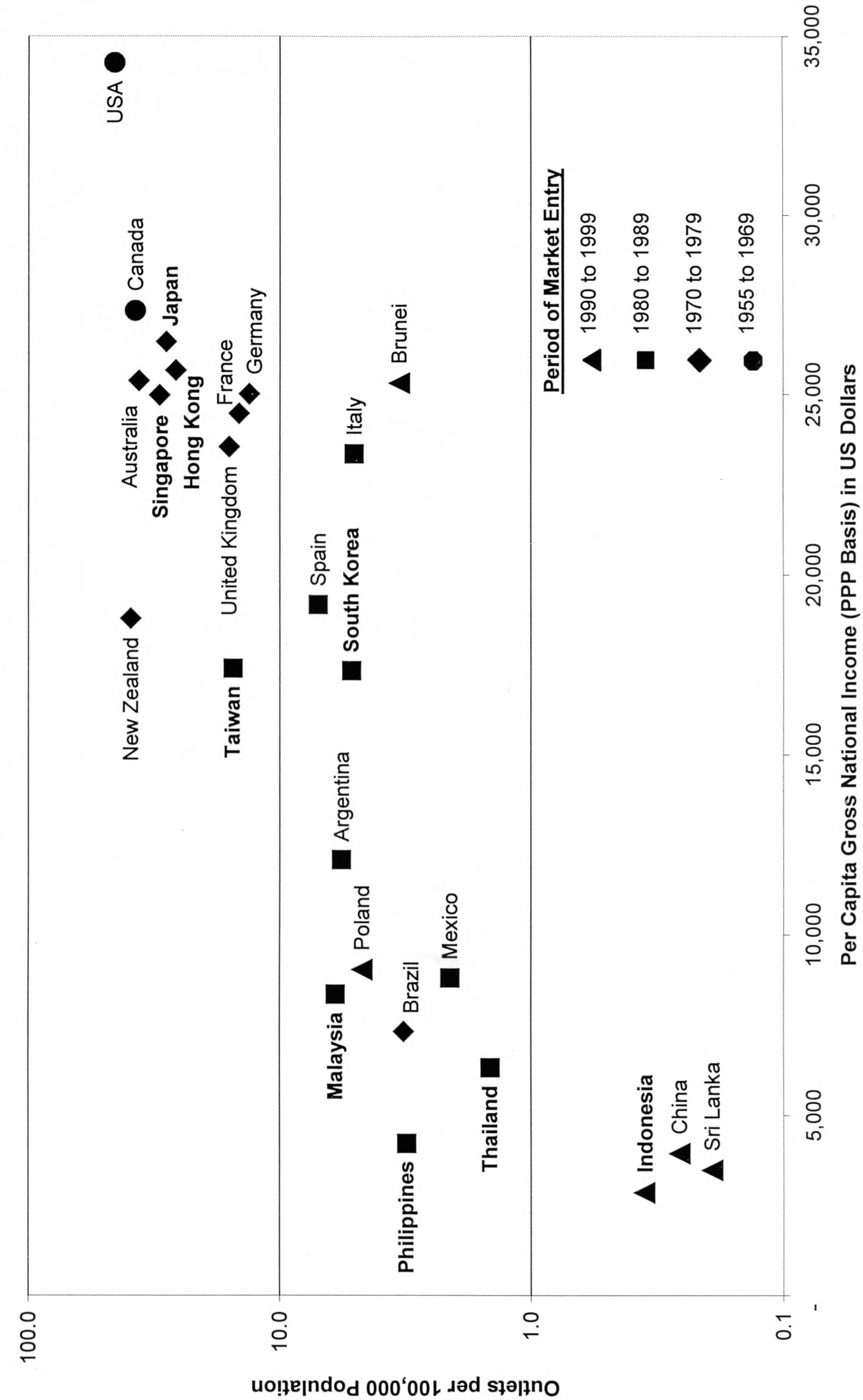
Figure 31
McDonald's Market Saturation Based on Population (2000)



firstly that McDonald's outlets are indeed mainly concentrated in urban areas. (It should be noted that the populations in Singapore and Hong Kong are considered 100 percent urban.) Figure 31 also shows clearly that Singapore, Japan, and Hong Kong are closely approaching the saturation levels of Western countries, such as Australia, Canada, and New Zealand. In fact, McDonald's penetration of these markets has already surpassed those in the United Kingdom, France, Germany, and Spain. Taiwan finds itself right in the middle of this second group, of Western countries, suggesting that it too has perhaps reached the point of diminishing market growth potential. Looking further down the curve we find Malaysia and South Korea, with less than half the market penetration of Taiwan. Much smaller still is McDonald's presence in the Philippines, Thailand, and Indonesia, three countries with a combined population of almost 350 million. Hardly surprising, China and India barely even appear on the chart.

Population alone is only the coarsest of indicators, and to judge more accurately the market potential for McDonald's we must also recognize that in several countries in Asia a large percentage of the population could not afford to buy even a single hamburger at the chain. Another parameter should therefore be included to reflect different average income levels in the various markets. Thus, Figure 32 presents McDonald's market penetration, again in terms of outlets per 100,000 population, as a function of per capita gross national income expressed on a purchasing power parity (PPP) basis. Also noted on this figure is the decade in which McDonald's entered each market. Once again it is apparent that McDonald's has achieved slightly higher levels of market penetration in Japan, Singapore and Hong Kong than in Western markets of similar age and income levels (France, Germany, and the United Kingdom). Taiwan looks to be even closer to

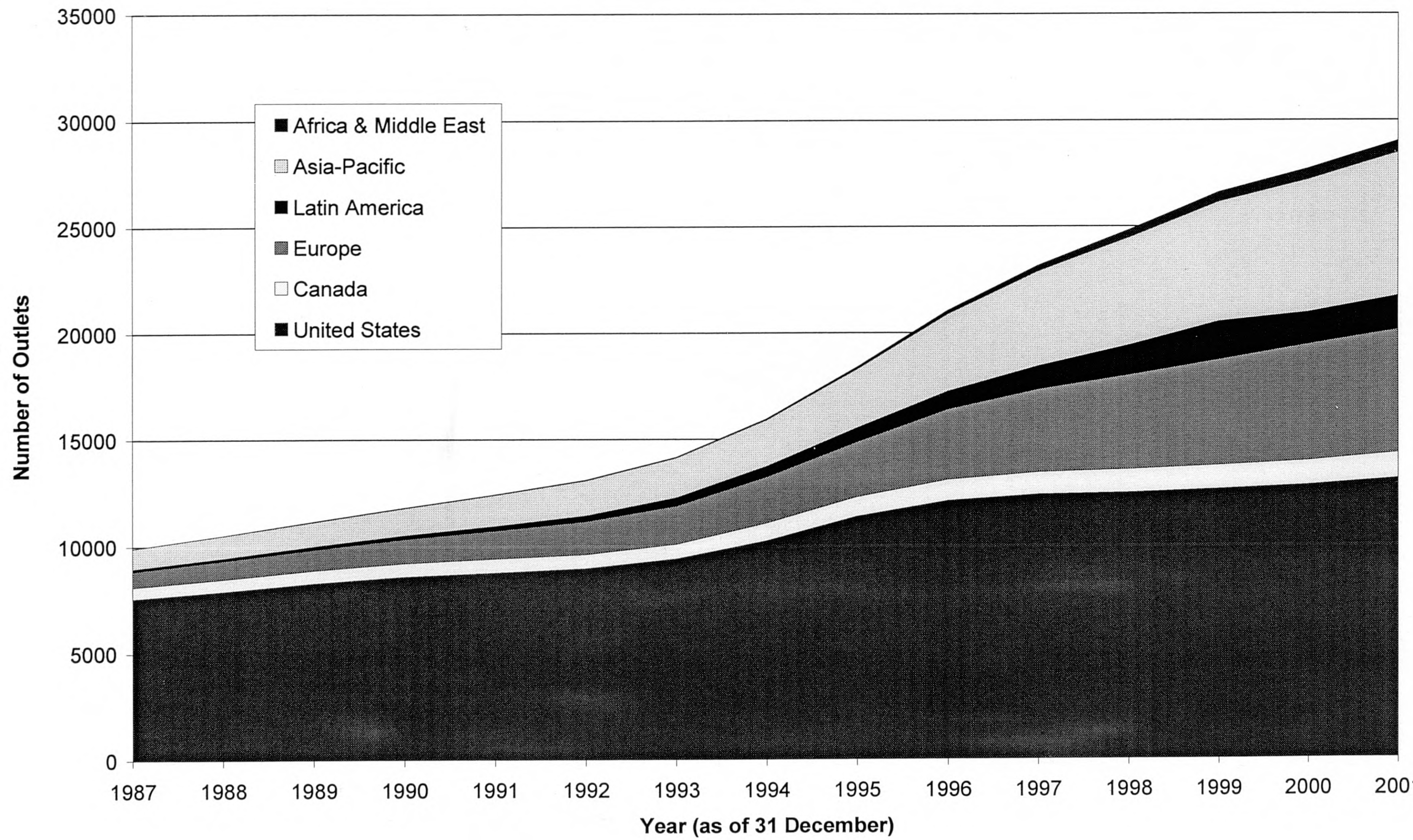
Figure 32
McDonald's Market Saturation Based on National Income (2000)



reaching a saturation point, given its lower average income; while South Korea shows considerable additional growth potential for McDonald's. Of the other Asian markets McDonald's entered during the 1980s, Thailand appears to have the greatest potential, with an income between that of Malaysia and the Philippines, but a considerably lower market penetration. In fact, when viewed in the context of per capita income levels, McDonald's development in the Philippines seems to be ahead the typical pace (not accounting, of course, for the obvious differences in consumer food preferences that make the Philippines a more attractive market). Well below the rest of Southeast Asia lies Indonesia, which despite having the lowest income level exhibits perhaps an even greater long-term potential due to its large population. It seems that McDonald's has much to gain from future economic development in Asia.

What does Asia mean to McDonald's? One need only look at the distribution of McDonald's restaurants worldwide to see that Asia, and Southeast Asia in particular with its young populations, is one of the keys to the company's future growth. As shown in Figure 33, unit growth in the United States and Canada has dramatically slowed over the last five years, and the number of units in Latin American market has actually contracted slightly, leaving Europe (mainly Eastern Europe) and Asia as the main engines of growth for McDonald's. If the recent rates of expansion are maintained, within a decade there will be more McDonald's restaurants in Asia than in North America. At what point will visitors from Asia find it remarkable that even in the United States McDonald's seems to be everywhere?

Figure 33
Distribution of McDonald's Outlets Worldwide



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