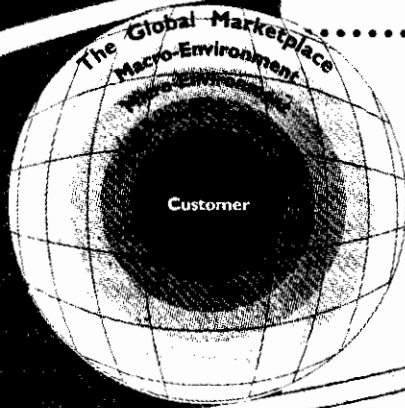


CASE 34



Kentucky Fried Chicken and the Global Fast-Food Industry

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Kentucky Fried Chicken Corporation (KFC) was the world's largest chicken restaurant chain and third largest fast-food chain. KFC held over 55 percent of the U.S. market in terms of sales and operated over 10,200 restaurants worldwide in 1998. It opened 376 new restaurants in 1997 (more than one restaurant a day) and operated in 79 countries. One of the first fast-food chains to go international during the late 1960s, KFC has developed one of the world's most recognizable brands.

Japan, Australia, and the United Kingdom accounted for the greatest share of KFC's international expansion during the 1970s and 1980s. During the 1990s, KFC turned its attention to other international markets that offered significant opportunities for growth. China, with a population of over one billion, and Europe, with a population roughly equal to the United States, offered such opportunities. Latin America also offered a unique

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opportunity because of the size of its markets, its common language and culture, and its geographic proximity to the United States. Mexico was of particular interest because of the North American Free Trade Agreement (NAFTA), a free-trade zone between Canada, the United States, and Mexico that went into effect in 1994.

Prior to 1990, KFC expanded into Latin America primarily through company-owned restaurants in Mexico and Puerto Rico. Company-owned restaurants gave KFC greater control over its operations than franchised or licensed restaurants. By 1995, KFC also had established company-owned restaurants in Venezuela and Brazil. In addition, it had established franchised units in numerous Caribbean countries. During the early 1990s, KFC shifted to a two-tiered strategy in Latin America. First, it established 29 franchised restaurants in Mexico following enactment of Mexico's new franchise law in 1990. This allowed KFC to expand outside its company restaurant base in Mexico City, Guadalajara, and Monterrey. KFC was one of many

U.S. fast-food, retail, and hotel chains to begin franchising in Mexico following the new franchise law. Second, KFC began an aggressive franchise building program in South America. By 1998, it was operating franchised restaurants in 32 Latin American countries. Much of this growth was in Brazil, Chile, Colombia, Ecuador, and Peru.

COMPANY HISTORY

Fast-food franchising was still in its infancy in 1952 when Harland Sanders began his travels across the United States to speak with prospective franchisees about his "Colonel Sanders Recipe Kentucky Fried Chicken." By 1960, "Colonel" Sanders had granted KFC franchises to over 200 take-home retail outlets and restaurants across the United States. He had also succeeded in establishing a number of franchises in Canada. By 1963, the number of KFC franchises had risen to over 300, and revenues had reached \$500 million.

By 1964, at the age of 74, the Colonel had tired of running the day-to-day operations of his business and was eager to concentrate on public relations issues. Therefore, he sought out potential buyers, eventually deciding to sell the business to two Louisville businessmen—Jack Massey and John Young Brown, Jr.—for \$2 million. The Colonel stayed on as a public relations man and goodwill ambassador for the company.

During the next 5 years, Massey and Brown concentrated on growing KFC's franchise system across the United States. In 1966, they took KFC public, and the company was listed on the New York Stock Exchange. By the late 1960s, a strong foothold had been established in the United States, and Massey and Brown turned their attention to international markets. In 1969, a joint venture was signed with Mitsuoshi Shoji Kaisha, Ltd., in Japan, and the rights to operate 14 existing KFC franchises in England were acquired. Subsidiaries also were established in Hong Kong, South Africa, Australia, New Zealand, and Mexico. By 1971, KFC had 2450 franchises and 600 company-owned restaurants worldwide and was operating in 48 countries.

Heublein, Inc.

In 1971, KFC entered negotiations with Heublein, Inc., to discuss a possible merger. The decision to

seek a merger candidate was partially driven by Brown's desire to pursue other interests, including a political career (Brown was elected governor of Kentucky in 1977). Several months later, Heublein acquired KFC. Heublein was in the business of producing vodka, mixed cocktails, dry gin, cordials, beer, and other alcoholic beverages. However, Heublein had little experience in the restaurant business. Conflicts quickly erupted between Colonel Sanders, who continued to act in a public relations capacity, and Heublein management. Colonel Sanders became increasingly distraught over quality control issues and restaurant cleanliness. By 1977, new restaurant openings had slowed to about 20 per year. Few restaurants were being remodeled, and service quality had declined.

In 1977, Heublein sent in a new management team to redirect KFC's strategy. A "back-to-the-basics" strategy was immediately implemented. New unit construction was discontinued until existing restaurants could be upgraded and operating problems eliminated. Restaurants were refurbished, an emphasis was placed on cleanliness and service, marginal products were eliminated, and product consistency was reestablished. By 1982, KFC had succeeded in establishing a successful strategic focus and was again aggressively building new units.

R. J. Reynolds Industries, Inc.

In 1982, R. J. Reynolds Industries, Inc. (RJR), merged Heublein into a wholly owned subsidiary. The merger with Heublein represented part of RJR's overall corporate strategy of diversifying into unrelated businesses, including energy, transportation, food, and restaurants. RJR's objective was to reduce its dependence on the tobacco industry, which had driven RJR sales since its founding in North Carolina in 1875. Sales of cigarettes and tobacco products, while profitable, were declining because of reduced consumption in the United States. This was mainly the result of an increased awareness among Americans about the negative health consequences of smoking.

RJR had no more experience in the restaurant business than did Heublein. However, it decided to take a hands-off approach to managing KFC. Whereas Heublein had installed its own top management at KFC headquarters, RJR left KFC management largely intact, believing that existing KFC managers were better qualified to operate KFC's

businesses than were its own managers. In doing so, RJR avoided many of the operating problems that plagued Heublein. This strategy paid off for RJR as KFC continued to expand aggressively and profitably under RJR ownership. In 1985, RJR acquired Nabisco Corporation for \$4.9 billion. Nabisco sold a variety of well-known cookies, crackers, cereals, confectioneries, snacks, and other grocery products. The merger with Nabisco represented a decision by RJR to concentrate its diversification efforts on the consumer foods industry. It subsequently divested many of its nonconsumer food businesses. RJR sold KFC to PepsiCo, Inc., one year later.

PEPSICO, INC.

Corporate Strategy

PepsiCo, Inc., was formed in 1965 with the merger of the Pepsi-Cola Co. and Frito-Lay, Inc. The merger of these companies created one of the largest consumer products companies in the United States. Pepsi-Cola's traditional business was the sale of soft drink concentrates to licensed independent and company-owned bottlers that manufactured, sold, and distributed Pepsi-Cola soft drinks. Pepsi-Cola's best known trademarks were Pepsi-Cola, Diet Pepsi, Mountain Dew, and Slice. Frito-Lay manufactured and sold a variety of snack foods, including Fritos Corn Chips, Lay's Potato Chips, Ruffles Potato Chips, Doritos, Tostitos Tortilla Chips, and Chee-tos Cheese Flavored Snacks. PepsiCo quickly embarked on an aggressive acquisition program similar to that pursued by RJR during the 1980s, buying a number of companies in areas unrelated to its major businesses. Acquisitions included North American Van Lines, Wilson Sporting Goods, and Lee Way Motor Freight. However, success in operating these businesses failed to live up to expectations, mainly because the management skills required to operate these businesses lay outside of PepsiCo's area of expertise.

Poor performance in these businesses led then-chairman and chief executive officer Don Kendall to restructure PepsiCo's operations in 1984. First, businesses that did not support PepsiCo's consumer product orientation, such as North American Van Lines, Wilson Sporting Goods, and Lee Way Motor Freight, were divested. Second, PepsiCo's for-

eign bottling operations were sold to local businesspeople who better understood the culture and business environment in their respective countries. Third, Kendall reorganized PepsiCo along three lines: soft drinks, snack foods, and restaurants.

Restaurant Business and Acquisition of KFC

PepsiCo first entered the restaurant business in 1977 when it acquired Pizza Hut's 3200-unit restaurant system. Taco Bell was merged into a division of PepsiCo in 1978. The restaurant business completed PepsiCo's consumer product orientation. The marketing of fast food followed many of the same patterns as the marketing of soft drinks and snack foods. Therefore, PepsiCo believed that its management skills could be easily transferred among its three business segments. This was compatible with PepsiCo's practice of frequently moving managers among its business units as a way of developing future top executives. PepsiCo's restaurant chains also provided an additional outlet for the sale of Pepsi soft drinks. Pepsi-Cola soft drinks and fast-food products also could be marketed together in the same television and radio segments, thereby providing higher returns for each advertising dollar. To complete its diversification into the restaurant segment, PepsiCo acquired Kentucky Fried Chicken Corporation from RJR-Nabisco for \$841 million in 1986. The acquisition of KFC gave PepsiCo the leading market share in chicken (KFC), pizza (Pizza Hut), and Mexican food (Taco Bell), three of the four largest and fastest-growing segments within the U.S. fast-food industry.

Management

Following the acquisition by PepsiCo, KFC's relationship with its parent company underwent dramatic changes. RJR had operated KFC as a semiautonomous unit, satisfied that KFC management understood the fast-food business better than they. In contrast, PepsiCo acquired KFC in order to complement its already strong presence in the fast-food market. Rather than allowing KFC to operate autonomously, PepsiCo undertook sweeping changes. These changes included negotiating a new franchise contract to give PepsiCo more control over its franchisees, reducing staff in order to cut costs, and replacing KFC managers with its own. In 1987, a rumor spread through KFC's headquarters in

Louisville that the new personnel manager, who had just relocated from PepsiCo's headquarters in New York, was overheard saying that "there will be no more home grown tomatoes in this organization."

Such statements by PepsiCo personnel, uncertainties created by several restructurings that led to layoffs throughout the KFC organization, the replacement of KFC personnel with PepsiCo managers, and conflicts between KFC and PepsiCo's corporate cultures created a morale problem within KFC. KFC's culture was built largely on Colonel Sanders' laid-back approach to management. Employees enjoyed relatively good employment stability and security. Over the years, a strong loyalty had been created among KFC employees and franchisees, mainly because of the efforts of Colonel Sanders to provide for his employees' benefits, pension, and other nonincome needs. In addition, the southern environment of Louisville resulted in a friendly, relaxed atmosphere at KFC's corporate offices. This corporate culture was left essentially unchanged during the Heublein and RJR years.

In stark contrast to KFC, PepsiCo's culture was characterized by a strong emphasis on performance. Top performers expected to move up through the ranks quickly. PepsiCo used its KFC, Pizza Hut, Taco Bell, Frito Lay, and Pepsi-Cola divisions as training grounds for its top managers, rotating its best managers through its five divisions on average every 2 years. This practice created immense pressure on managers to continuously demonstrate their managerial prowess within short periods, in order to maximize their potential for promotion. This practice also left many KFC managers with the feeling that they had few career opportunities with the new company. One PepsiCo manager commented, "You may have performed well last year, but if you don't perform well this year, you're gone, and there are 100 ambitious guys with Ivy League MBAs at PepsiCo who would love to take your position." An unwanted effect of this performance-driven culture was that employee loyalty often was lost, and turnover tended to be higher than in other companies.

Kyle Craig, president of KFC's U.S. operations, was asked about KFC's relationship with its corporate parent. He commented:

The KFC culture is an interesting one because I think it was dominated by a lot of KFC folks, many of whom have been around since the days of the Colonel. Many of those people were very

intimidated by the PepsiCo culture, which is a very high performance, high accountability, highly driven culture. People were concerned about whether they would succeed in the new culture. Like many companies, we have had a couple of downsizings which further made people nervous. Today, there are fewer old KFC people around and I think to some degree people have seen that the PepsiCo culture can drive some pretty positive results. I also think the PepsiCo people who have worked with KFC have modified their cultural values somewhat and they can see that there were a lot of benefits in the old KFC culture.

PepsiCo pushes its companies to perform strongly, but whenever there is a slip in performance, it increases the culture gap between PepsiCo and KFC. I have been involved in two downsizings over which I have been the chief architect. They have been probably the two most gut-wrenching experiences of my career. Because you know you're dealing with peoples' lives and their families, these changes can be emotional if you care about the people in your organization. However, I do fundamentally believe that your first obligation is to the entire organization.

A second problem for PepsiCo was its poor relationship with KFC franchisees. A month after becoming president and chief executive officer in 1989, John Cranor addressed KFC's franchisees in Louisville in order to explain the details of the new franchise contract. This was the first contract change in 13 years. It gave PepsiCo greater power to take over weak franchises, relocate restaurants, and make changes in existing restaurants. In addition, restaurants would no longer be protected from competition from new KFC units, and it gave PepsiCo the right to raise royalty fees on existing restaurants as contracts came up for renewal. After Cranor finished his address, there was an uproar among the attending franchisees, who jumped to their feet to protest the changes. The franchisees had long been accustomed to relatively little interference from management in their day-to-day operations (a tradition begun by Colonel Sanders). This type of interference, of course, was a strong part of PepsiCo's philosophy of demanding change. KFC's franchise association later sued PepsiCo over the new contract. The contract remained unresolved until 1996, when the most objectionable parts of the contract were removed by KFC's new presi-

dent and CEO, David Novak. A new contract was ratified by KFC's franchisees in 1997.

PepsiCo's Divestiture of KFC, Pizza Hut, and Taco Bell

PepsiCo's strategy of diversifying into three distinct but related markets—soft drinks, snack foods, and fast-food restaurants—created one of the world's largest consumer products companies and a portfolio of some of the world's most recognizable brands. Between 1990 and 1996, PepsiCo grew at an annual rate of over 10 percent, surpassing \$31 billion in sales in 1996. However, PepsiCo's sales growth masked troubles in its fast-food businesses. Operating margins (profit as a percent of sales) at Pepsi-Cola and Frito Lay averaged 12 and 17 percent between 1990 and 1996, respectively. During the same period, margins at KFC, Pizza Hut, and Taco Bell fell from an average of over 8 percent in 1990 to a little more than 4 percent in 1996. Declining margins in the fast-food chains reflected increasing maturity in the U.S. fast-food industry, more intense competition among U.S. fast-food competitors, and the aging of KFC and Pizza Hut's restaurant base. As a result, PepsiCo's restaurant chains absorbed nearly one-half of PepsiCo's annual capital spending during the 1990s. However,

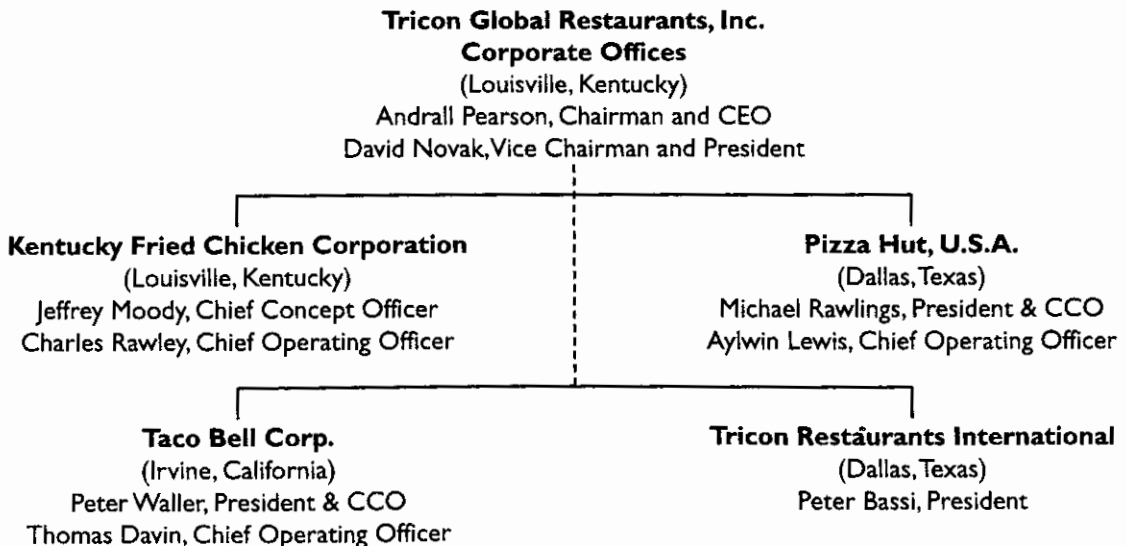
they generated less than one-third of PepsiCo's cash flows. Therefore, cash was diverted from PepsiCo's soft drink and snack food businesses to its restaurant businesses. This reduced PepsiCo's return on assets, made it more difficult to compete effectively with Coca-Cola, and hurt its stock price. In 1997, PepsiCo spun off its restaurant businesses into a new company called Tricon Global Restaurants, Inc. (see Exhibit A). The new company was based in KFC's headquarters in Louisville, Kentucky. PepsiCo's objective was to reposition itself as a packaged goods company, to strengthen its balance sheet, and to create more consistent earning growth. PepsiCo received a one-time distribution from Tricon of \$4.7 billion, \$3.7 billion of which was used to pay off short-term debt. The balance was earmarked for stock repurchases.

FAST-FOOD INDUSTRY

According to the National Restaurant Association (NRA), food-service sales topped \$320 billion for the approximately 500,000 restaurants and other food outlets making up the U.S. restaurant industry in 1997. The NRA estimated that sales in the fast-food segment of the food service industry grew 5.2 percent to \$104 billion, up from \$98 billion in

EXHIBIT A

Tricon Global Restaurants, Inc.—Organizational Chart (1998)



1996. This marked the fourth consecutive year that fast-food sales either matched or exceeded sales in full-service restaurants, which grew 4.1 percent to \$104 billion in 1997. The growth in fast-food sales reflected the long, gradual change in the restaurant industry from an industry once dominated by independently operated sit-down restaurants to an industry fast becoming dominated by fast-food restaurant chains. The U.S. restaurant industry as a whole grew by approximately 4.2 percent in 1997.

Major Fast-Food Segments

Six major business segments made up the fast-food segment of the food service industry. Sales data for the leading restaurant chains in each segment are shown in Exhibit B. Most striking is the dominance of McDonald's, which had sales of over \$16 billion in 1996. This represented 16.6 percent of U.S. fast-food sales, or nearly 22 percent of sales among the nation's top 30 fast-food chains. Sales at McDonald's restaurants average \$1.3 million per year, compared with about \$820,000 for the average U.S. fast-food restaurant. Tricon Global Restaurants (KFC, Pizza Hut, and Taco Bell) had U.S. sales of \$13.4 billion in 1996. This represented 13.6 percent of U.S. fast-food sales and 17.9 percent of the top 30 fast-food chains.

Sandwich chains made up the largest segment of the fast-food market. McDonald's controlled 35 percent of the sandwich segment, while Burger King ran a distant second with a 15.6 percent market share. Competition had become particularly intense within the sandwich segment as the U.S. fast-food market became more saturated. In order to increase sales, chains turned to new products to win customers away from other sandwich chains, introduced products traditionally offered by non-sandwich chains (such as pizzas, fried chicken, and tacos), streamlined their menus, and upgraded product quality. Burger King recently introduced its Big King, a direct clone of the Big Mac. McDonald's quickly retaliated by introducing its Big 'n Tasty, a direct clone of the Whopper. Wendy's introduced chicken pita sandwiches, and Taco Bell introduced sandwiches called "wraps," breads stuffed with various fillings. Hardee's successfully introduced fried chicken in most of its restaurants. In addition to new products, chains lowered pricing, improved customer service, cobranded with other fast-food chains, and established restaurants in nontraditional

locations (e.g., McDonald's installed restaurants in Wal-Mart stores across the country) to beef up sales.

The second largest fast-food segment was dinner houses, dominated by Red Lobster, Applebee's, Olive Garden, and Chili's. Between 1988 and 1996, dinner houses increased their share of the fast-food market from 8 to over 13 percent. This increase came mainly at the expense of grilled buffet chains, such as Ponderosa, Sizzler, and Western Sizzlin'. The market share of steak houses fell from 6 percent in 1988 to under 4 percent in 1996. The rise of dinner houses during the 1990s was partially the result of an aging and wealthier population that increasingly demanded higher-quality food in more upscale settings. However, rapid construction of new restaurants, especially among relative newcomers, such as Romano's Macaroni Grill, Lone Star Steakhouse, and Outback Steakhouse, resulted in overcapacity within the dinner house segment. This reduced per-restaurant sales and further intensified competition. Eight of the sixteen largest dinner houses posted growth rates in excess of 10 percent in 1996. Romano's Macaroni Grill, Lone Star Steakhouse, Chili's, Outback Steakhouse, Applebee's, Red Robin, Fuddruckers, and Ruby Tuesday grew at rates of 82, 41, 32, 27, 23, 14, 11, and 10 percent, respectively.

The third largest fast-food segment was pizza, long dominated by Pizza Hut. While Pizza Hut controlled over 46 percent of the pizza segment in 1996, its market share has slowly eroded because of intense competition and its aging restaurant base. Domino's Pizza and Papa John's Pizza have been particularly successful. Little Caesars is the only pizza chain to remain predominantly a take-out chain, although it recently began home delivery. However, its policy of charging customers \$1 per delivery damaged its perception among consumers as a high-value pizza chain. Home delivery, successfully introduced by Domino's and Pizza Hut, was a driving force for success among the market leaders during the 1970s and 1980s. However, the success of home delivery drove competitors to look for new methods of increasing their customer bases. Pizza chains diversified into nonpizza items (e.g., chicken wings at Domino's, Italian cheese bread at Little Caesars, and stuffed crust pizza at Pizza Hut), developed nontraditional items (e.g., airport kiosks and college campuses), offered special promotions, and offered new pizza variations with

EXHIBIT B**Leading U.S. Fast-Food Chains (Ranked by 1996 Sales, \$000s)**

Sandwich Chains			Family Restaurants		
	Sales	Share		Sales	Share
McDonald's	16,370	35.0%	Denny's	1,850	21.2%
Burger King	7,300	15.6%	Shoney's	1,220	14.0%
Taco Bell	4,575	9.8%	Big Boy	945	10.8%
Wendy's	4,360	9.3%	Int'l House of Pancakes	797	9.1%
Hardee's	3,055	6.5%	Cracker Barrel	734	8.4%
Subway	2,700	5.8%	Perkins	678	7.8%
Arby's	1,867	4.0%	Friendly's	597	6.8%
Dairy Queen	1,225	2.6%	Bob Evans	575	6.6%
Jack-in-the-Box	1,207	2.6%	Waffle House	525	6.0%
Sonic Drive-In	985	2.1%	Coco's	278	3.2%
Carl's Jr.	648	1.4%	Steak 'n Shake	275	3.2%
Other chains	2,454	5.2%	Village Inn	246	2.8%
Total	46,745	100.0%	Total	8,719	100.0%

Dinner Houses			Pizza Chains		
	Sales	Share		Sales	Share
Red Lobster	1,810	15.7%	Pizza Hut	4,927	46.4%
Applebee's	1,523	13.2%	Domino's Pizza	2,300	21.7%
Olive Garden	1,280	11.1%	Little Caesars	1,425	13.4%
Chili's	1,242	10.7%	Papa John's	619	5.8%
Outback Steakhouse	1,017	8.8%	Sbarros	400	3.8%
T.G.I. Friday's	935	8.1%	Round Table Pizza	385	3.6%
Ruby Tuesday	545	4.7%	Chuck E. Cheese's	293	2.8%
Lone Star Steakhouse	460	4.0%	Godfather's Pizza	266	2.5%
Bennigan's	458	4.0%	Total	10,614	100.0%
Romano's Macaroni Grill	344	3.0%			
Other dinner houses	1,942	16.8%			
Total	11,557	100.0%			

Grilled Buffet Chains			Chicken Chains		
	Sales	Share		Sales	Share
Golden Corral	711	22.8%	KFC	3,900	57.1%
Ponderosa	680	21.8%	Boston Market	1,167	17.1%
Ryan's	604	19.4%	Pepeye's Chicken	666	9.7%
Sizzler	540	17.3%	Chick-fil-A	570	8.3%
Western Sizzlin'	332	10.3%	Church's Chicken	529	7.7%
Quincy's	259	8.3%	Total	6,832	100.0%
Total	3,116	100.0%			

an emphasis on high-quality ingredients (e.g., Roma Herb and Garlic Crunch pizza at Domino's and Buffalo Chicken Pizza at Round Table Pizza).

Chicken Segment

KFC continued to dominate the chicken segment, with 1997 sales of \$4 billion (see Exhibit C). Its nearest competitor, Boston Market, was second with sales of \$1.2 billion. KFC operated 5120 restaurants in the United States in 1998, eight fewer restaurants than in 1993. Rather than building new restaurants in the already saturated U.S. market, KFC focused on building restaurants abroad. In the United States, KFC focused on closing unprofitable restaurants, upgrading existing restaurants

with new exterior signage, and improving product quality. The strategy paid off. While overall U.S. sales during the last 10 years remained flat, annual sales per unit increased steadily in 8 of the last 9 years.

Despite KFC's continued dominance within the chicken segment, it has lost market share to Boston Market, a new restaurant chain emphasizing roasted rather than fried chicken. Boston Market has successfully created the image of an upscale deli offering healthy, "home style" alternatives to fried chicken and other "fast foods." It has broadened its menu beyond rotisserie chicken to include ham, turkey, meat loaf, chicken pot pie, and deli sandwiches. In order to minimize its image as a fast-food restaurant, it has refused to put drive-thrus in its restaurants and has established most of its

EXHIBIT C

Top U.S. Chicken Chains

Sales (\$ M)	1992	1993	1994	1995	1996	1997	Growth Rate (%)
KFC	3,400	3,400	3,500	3,700	3,900	4,000	3.3
Boston Market	43	147	371	754	1,100	1,197	94.5
Popeye's	545	569	614	660	677	727	5.9
Chick-fil-A	356	396	451	502	570	671	11.9
Church's	414	440	465	501	526	574	6.8
Total	4,758	4,952	5,401	6,118	6,772	7,170	8.5
U.S. restaurants							
KFC	5,089	5,128	5,149	5,142	5,108	5,120	0.1
Boston Market	83	217	534	829	1,087	1,166	69.6
Popeye's	769	769	853	889	894	949	4.3
Chick-fil-A	487	545	534	825	717	762	9.0
Church's	944	932	937	953	989	1,070	2.5
Total	7,372	7,591	8,007	8,638	8,795	9,067	4.2
Sales per unit (\$000s)							
KFC	668	663	680	720	764	781	3.2
Boston Market	518	677	695	910	1,012	1,027	14.7
Popeye's	709	740	720	743	757	767	1.6
Chick-fil-A	731	727	845	608	795	881	3.8
Church's	439	472	496	526	531	537	4.1
Total	645	782	782	782	782	782	3.9

Source: Tricon Global Restaurants, Inc., 1997 Annual Report; Boston Chicken, Inc., 1997 Annual Report; Chick-fil-A, corporate headquarters, Atlanta; AFC Enterprises, Inc., 1997 Annual Report.

units in outside shopping malls rather than in free-standing units at intersections so characteristic of other fast-food restaurants.

In 1993, KFC introduced its own rotisserie chicken, called Rotisserie Gold, to combat Boston Market. However, it quickly learned that its customer base was considerably different from that of Boston Market's. KFC's customers liked KFC chicken despite the fact that it was fried. In addition, customers did not respond well to the concept of buying whole chickens for take-out. They preferred instead to buy chicken by the piece. KFC withdrew its rotisserie chicken in 1996 and introduced a new line of roasted chicken called Tender Roast, which could be sold by the piece and mixed with its Original Recipe and Extra Crispy Chicken.

Other major competitors within the chicken segment included Popeye's Famous Fried Chicken and Church's Chicken (both subsidiaries of AFC Enterprises in Atlanta), Chick-fil-A, Bojangle's, El Pollo Loco, Grandy's, Kenny Rogers Roasters, Mrs. Winner's, and Pudge's. Both Church's and Popeye's had similar strategies—to compete head on with other “fried chicken” chains. Unlike KFC, neither chain offered rotisserie chicken, and nonfried chicken products were limited. Chick-fil-A focused exclusively on pressure-cooked and char-grilled skinless chicken breast sandwiches, which it served to customers in sit-down restaurants located predominantly in shopping malls. As many malls added food courts, often consisting of up to 15 fast-food units competing side by side, shopping malls became less enthusiastic about allocating separate store space to food chains. Therefore, in order to complement its existing restaurant base in shopping malls, Chick-fil-A began to open smaller units in shopping mall food courts, hospitals, and colleges. It also opened free-standing units in selected locations.

Demographic Trends

A number of demographic and societal trends contributed to increased demand for food prepared away from home. Because of the high divorce rate in the United States and the fact that people married later in life, single-person households represented about 25 percent of all U.S. households, up from 17 percent in 1970. This increased the number of individuals choosing to eat out rather than

eat at home. The number of married women working outside the home also has increased dramatically during the last 25 years. About 59 percent of all married women have careers. According to the Conference Board, 64 percent of all married households will be double-income families by 2000. About 80 percent of households headed by individuals between the ages of 25 and 44 (both married and unmarried) will be double-income. Greater numbers of working women increased family incomes. According to *Restaurants & Institutions* magazine, more than one-third of all households had incomes of at least \$50,000 in 1996. About 8 percent of all households had annual incomes over \$100,000. The combination of higher numbers of dual-career families and rising incomes meant that fewer families had time to prepare food at home. According to Standard & Poor's *Industry Surveys*, Americans spent 55 percent of their food dollars at restaurants in 1995, up from 34 percent in 1970.

Fast-food restaurant chains met these demographic and societal changes by expanding their restaurant bases. However, by the early 1990s, the growth of traditional free-standing restaurants slowed as the U.S. market became saturated. The major exception was dinner houses, which continued to proliferate in response to Americans' increased passion for beef. Since 1990, the U.S. population has grown at an average annual rate of about 1 percent and reached 270 million people in 1997. Rising immigration since 1990 dramatically altered the ethnic makeup of the U.S. population. According to the Bureau of the Census, Americans born outside the United States made up 10 percent of the population in 1997. About 40 percent were Hispanic, while 24 percent were Asian. Nearly 30 percent of Americans born outside the United States arrived since 1990. As a result of these trends, restaurant chains expanded their menus to appeal to the different ethnic tastes of consumers, expanded into nontraditional locations such as department stores and airports, and made food more available through home delivery and take-out service.

Industry Consolidation and Mergers and Acquisitions

Lower growth in the U.S. fast-food market intensified competition for market share among restaur-

rant chains and led to consolidation, primarily through mergers and acquisitions, during the mid-1990s. Many restaurant chains found that market share could be increased more quickly and cheaply by acquiring an existing company rather than building new units. In addition, fixed costs could be spread across a larger number of restaurants. This raised operating margins and gave companies an opportunity to build market share by lowering prices. An expanded restaurant base also gave companies greater purchasing power over supplies. In 1990, Grand Metropolitan, a British company, purchased Pillsbury Co. for \$5.7 billion. Included in the purchase was Pillsbury's Burger King chain. Grand Met strengthened the franchise by upgrading existing restaurants and eliminated several levels of management in order to cut costs. This gave Burger King a long-needed boost in improving its position against McDonald's, its largest competitor. In 1988, Grand Met had purchased Wienerwald, a West German chicken chain, and the Spaghetti Factory, a Swiss chain.

Perhaps most important to KFC was Hardee's acquisition of 600 Roy Rogers restaurants from Marriott Corporation in 1990. Hardee's converted a large number of these restaurants to Hardee's units and introduced "Roy Rogers" fried chicken to its menu. By 1993, Hardee's had introduced fried chicken into most of its U.S. restaurants. Hardee's was unlikely to destroy the customer loyalty that KFC long enjoyed. However, it did cut into KFC's sales, because it was able to offer consumers a widened menu selection that appealed to a variety of family eating preferences. In 1997, Hardee's parent company, Imasco, Ltd., sold Hardee's to CKE Restaurants, Inc. CKE owned Carl's Jr., Rally's Hamburgers, and Checker's Drive-In. Boston Chicken, Inc., acquired Harry's Farmers Market, an Atlanta grocer that sold fresh quality prepared meals. The acquisition was designed to help Boston Chicken develop distribution beyond its Boston Market restaurants. AFC Enterprises, which operated Popeye's and Church's, acquired Chesapeake Bagel Bakery of McLean, Virginia, in order to diversify away from fried chicken and to strengthen its balance sheet.

The effect of these and other recent mergers and acquisitions on the industry was powerful. The top 10 restaurant companies controlled almost 60 percent of fast-food sales in the United States. The consolidation of a number of fast-food chains

within larger, financially more powerful parent companies gave restaurant chains strong financial and managerial resources that could be used to compete against small chains in the industry.

International Quick-Service Market

Because of the aggressive pace of new restaurant construction in the United States during the 1970s and 1980s, opportunities to expand domestically through new restaurant construction in the 1990s were limited. Restaurant chains that did build new restaurants found that the higher cost of purchasing prime locations resulted in immense pressure to increase annual per-restaurant sales in order to cover higher initial investment costs. Many restaurants began to expand into international markets as an alternative to continued domestic expansion. In contrast to the U.S. market, international markets offered large customer bases with comparatively little competition. However, only a few U.S. restaurant chains had defined aggressive strategies for penetrating international markets by 1998.

Three restaurant chains that had established aggressive international strategies were McDonald's, KFC, and Pizza Hut. McDonald's operated the largest number of restaurants. In 1998, it operated 23,132 restaurants in 109 countries (10,409 restaurants were located outside the United States). In comparison, KFC, Pizza Hut, and Taco Bell together operated 29,712 restaurants in 79, 88, and 17 countries, respectively (9126 restaurants were located outside the United States). Of these four chains, KFC operated the greatest percentage of its restaurants (50 percent) outside the United States. McDonald's, Pizza Hut, and Taco Bell operated 45, 31, and 2 percent of their units outside the United States. KFC opened its first restaurant outside the United States in the late 1950s. By the time PepsiCo acquired KFC in 1986, KFC was already operating restaurants in 55 countries. KFC's early expansion abroad, its strong brand name, and its managerial experience in international markets gave it a strong competitive advantage vis-à-vis other fast-food chains that were investing abroad for the first time.

Exhibit D shows *Hotels'* 1994 list of the world's 30 largest fast-food restaurant chains (*Hotels* discontinued reporting these data after 1994). Seventeen of the 30 largest restaurant chains (ranked by number of units) were headquartered in the United States. There were a number of possible explana-

EXHIBIT D

The World's 30 Largest Fast-Food Chains (Year-End 1993, Ranked by Number of Countries)

Rank	Chain	Location	Units	Countries
1	Pizza Hut	Dallas, Texas	10,433	80
2	McDonald's	Oakbrook, Illinois	23,132	70
3	KFC	Louisville, Kentucky	9,033	68
4	Burger King	Miami, Florida	7,121	50
5	Baskin Robbins	Glendale, California	3,557	49
6	Wendy's	Dublin, Ohio	4,168	38
7	Domino's Pizza	Ann Arbor, Michigan	5,238	36
8	TCBY	Little Rock, Arkansas	7,474	22
9	Dairy Queen	Minneapolis, Minnesota	5,471	21
10	Dunkin' Donuts	Randolph, Massachusetts	3,691	21
11	Taco Bell	Irvine, California	4,921	20
12	Arby's	Fort Lauderdale, Florida	2,670	18
13	Subway Sandwiches	Milford, Connecticut	8,477	15
14	Sizzler International	Los Angeles, California	681	14
15	Hardee's	Rocky Mount, North Carolina	4,060	12
16	Little Caesar's	Detroit, Michigan	4,600	12
17	Popeye's Chicken	Atlanta, Georgia	813	12
18	Denny's	Spartanburg, South Carolina	1,515	10
19	A&W Restaurants	Livonia, Michigan	707	9
20	T.G.I. Friday's	Minneapolis, Minnesota	273	8
21	Orange Julius	Minneapolis, Minnesota	480	7
22	Church's Fried Chicken	Atlanta, Georgia	1,079	6
23	Long John Silver's	Lexington, Kentucky	1,464	5
24	Carl's Jr.	Anaheim, California	649	4
25	Lotteria	Tokyo, Japan	795	4
26	Mos Burger	Tokyo, Japan	1,263	4
27	Skylark	Tokyo, Japan	1,000	4
28	Jack in the Box	San Diego, California	1,172	3
29	Quick Restaurants	Berchem, Belgium	876	3
30	Taco Time	Eugene, Oregon	300	3

Source: *Hotels*, May 1994; 1994 PepsiCo, Inc., Annual Report.

tions for the relative scarcity of fast-food restaurant chains outside the United States. First, the United States represented the largest consumer market in the world, accounting for over one-fifth of the world's gross domestic product (GDP). Therefore, the United States was the strategic focus of the largest restaurant chains. Second, Americans were more quick to accept the fast-food concept. Many other cultures had strong culinary traditions that were difficult to break down. Europeans, for example, had histories of frequenting more midscale

restaurants, where they spent hours in a formal setting enjoying native dishes and beverages. While KFC was again building restaurants in Germany by the late 1980s, it previously failed to penetrate the German market, because Germans were not accustomed to take-out food or to ordering food over the counter. McDonald's had greater success penetrating the German market because it made a number of changes in its menu and operating procedures in order to better appeal to German culture. For example, German beer was served in all of McDon-

ald's German restaurants. KFC had more success in Asia and Latin America, where chicken was a traditional dish.

Aside from cultural factors, international business carried risks not present in the U.S. market. Long distances between headquarters and foreign franchises often made it difficult to control the quality of individual restaurants. Large distances also caused servicing and support problems. Transportation and other resource costs were higher than in the domestic market. In addition, time, cultural, and language differences increased communication and operational problems. Therefore, it was reasonable to expect U.S. restaurant chains to expand domestically as long as they achieved corporate profit and growth objectives. As the U.S. market became saturated and companies gained expertise in international markets, more companies could be expected to turn to profitable international markets as a means of expanding restaurant bases and increasing sales, profits, and market share.

KENTUCKY FRIED CHICKEN CORPORATION

KFC's worldwide sales, which included sales of both company-owned and franchised restaurants,

EXHIBIT E

Top U.S. Chicken Chains—Market Share (%)

1988	72.1	0.0	12.0	5.8	10.1	100.0
1989	70.8	0.0	12.0	6.2	11.0	100.0
1990	71.3	0.0	12.3	6.6	9.8	100.0
1991	72.7	0.0	11.4	7.0	8.9	100.0
1992	71.5	0.9	11.4	7.5	8.7	100.0
1993	68.7	3.0	11.4	8.0	8.9	100.0
1994	64.8	6.9	11.3	8.4	8.6	100.0
1995	60.5	12.3	10.8	8.2	8.2	100.0
1996	57.6	16.2	10.0	8.4	7.8	100.0
1997	55.8	16.7	10.1	9.4	8.0	100.0
Change	-16.3	16.7	-1.9	3.6	-2.1	0.0

grew to \$8.0 billion in 1997. U.S. sales grew 2.6 percent over 1996 and accounted for about one-half of KFC's sales worldwide. KFC's U.S. share of the chicken segment fell 1.8 points to 55.8 percent (see Exhibit E). This marked the sixth consecutive year that KFC sustained a decline in market share. KFC's market share has fallen by 16.3 points since 1988, when it held a 72.1 percent market share. Boston Market, which established its first restaurant in 1992, increased its market share from 0 to 16.7 percent over the same period. On the surface, it appeared as though Boston Market's market-share gain was achieved by taking customers away from KFC. However, KFC's sales growth has remained fairly stable and constant over the last 10 years. Boston Market's success was largely a function of its appeal to consumers who did not regularly patronize KFC or other chicken chains that sold fried chicken. By appealing to a market niche that was previously unsatisfied, Boston Market was able to expand the existing consumer base within the chicken segment of the fast-food industry.

Refranchising Strategy

The relatively low growth rate in sales in KFC's domestic restaurants during the 1992-1997 period was largely the result of KFC's decision in 1993 to

begin selling company-owned restaurants to franchisees. When Colonel Sanders began to expand the Kentucky Fried Chicken system in the late 1950s, he established KFC as a system of independent franchisees. This was done in order to minimize his involvement in the operations of individual restaurants and to concentrate on the things he enjoyed the most—cooking, product development, and public relations. This resulted in a fiercely loyal and independent group of franchisees. PepsiCo's strategy when it acquired KFC in 1986 was to integrate KFC's operations in the PepsiCo system, in order to take advantage of operational, financial, and marketing synergies. However, such a strategy demanded that PepsiCo become more involved in decisions over franchise operations, menu offerings, restaurant management, finance, and marketing. This was met by resistance with KFC franchisees, who fiercely opposed increased control by the corporate parent. One method for PepsiCo to deal with this conflict was to expand through company-owned restaurants rather than through franchising. PepsiCo also used its strong cash flows to buy back unprofitable franchised

restaurants, which could then be converted into company-owned restaurants. In 1986, company-owned restaurants made up 26 percent of KFC's U.S. restaurant base. By 1993, they made up about 40 percent (see Exhibit F).

While company-owned restaurants were relatively easier to control compared with franchises, they also required higher levels of investment. This meant that high levels of cash were diverted from PepsiCo's soft drink and snack food businesses into its restaurant businesses. However, the fast-food industry delivered lower returns than the soft drink and snack foods industries. Consequently, increased investment in KFC, Pizza Hut, and Taco Bell had a negative effect on PepsiCo's consolidated return on assets. By 1993, investors became concerned that PepsiCo's return on assets did not match returns delivered by Coca-Cola. In order to shore up its return on assets, PepsiCo decided to reduce the number of company-owned restaurants by selling them back to franchisees. This strategy lowered overall company sales but also lowered the amount of cash tied up in fixed assets, provided PepsiCo with one-time cash flow benefits from initial fees

EXHIBIT F

KFC Restaurant Count (U.S.)

	Company- Owned	% Total	Franchised/ Licensed	% Total	Total
1986	1,246	26.4	3,474	73.6	4,720
1987	1,250	26.0	3,564	74.0	4,814
1988	1,262	25.8	3,637	74.2	4,899
1989	1,364	27.5	3,597	72.5	4,961
1990	1,389	27.7	3,617	72.3	5,006
1991	1,836	36.6	3,186	63.4	5,022
1992	1,960	38.8	3,095	61.2	5,055
1993	2,014	39.5	3,080	60.5	5,094
1994	2,005	39.2	3,110	60.8	5,115
1995	2,026	39.4	3,111	60.6	5,137
1996	1,932	37.8	3,176	62.2	5,108
1997	1,850	36.1	3,270	63.9	5,120
1986–1993 Compounded annual growth rate					
	7.1%		-1.7%		1.1%
1993–1997 Compounded annual growth rate					
	-2.1%		1.5%		0.1%

Source: Tricon Global Restaurants, Inc., 1997 Annual Report; PepsiCo, Inc., Annual Reports, 1994, 1995, 1996, 1997.

charged to franchisees, and generated an annual stream of franchise royalties. Tricon Global continued this strategy after the spin-off in 1997.

Marketing Strategy

During the 1980s, consumers began to demand healthier foods, greater variety, and better service in a variety of nontraditional locations such as grocery stores, restaurants, airports, and outdoor events. This forced fast-food chains to expand menu offerings and to investigate nontraditional distribution channels and restaurant designs. Families also demanded greater value in the food they bought away from home. This increased pressure on fast-food chains to reduce prices and to lower operating costs in order to maintain profit margins.

Many of KFC's problems during the late 1980s surrounded its limited menu and inability to quickly bring new products to market. The popularity of its Original Recipe Chicken allowed KFC to expand without significant competition from other chicken competitors through the 1980s. As a result, new product introductions were never an important element of KFC's overall strategy. One of the most serious setbacks suffered by KFC came in 1989 as KFC prepared to add a chicken sandwich to its menu. While KFC was still experimenting with its chicken sandwich, McDonald's test marketed its McChicken sandwich in the Louisville market. Shortly thereafter, it rolled out the McChicken sandwich nationally. By beating KFC to the market, McDonald's was able to develop strong consumer awareness for its sandwich. This significantly increased KFC's cost of developing awareness of its own sandwich, which KFC introduced several months later. KFC eventually withdrew its sandwich because of low sales.

In 1991, KFC changed its logo in the United States from Kentucky Fried Chicken to KFC in order to reduce its image as a fried chicken chain. It continued to use the Kentucky Fried Chicken name internationally. It then responded to consumer demands for greater variety by introducing several products that would serve as alternatives to its Original Recipe Chicken. These included Oriental Wings, Popcorn Chicken, and Honey BBQ Chicken. It also introduced a dessert menu that included a variety of pies and cookies. In 1993, it rolled out Rotisserie Chicken and began to promote its lunch and dinner buffet. The buffet, which

included 30 items, was introduced into almost 1600 KFC restaurants in 27 states by year-end. In 1998, KFC sold three types of chicken—Original Recipe and Extra Crispy (fried chicken) and Tender Roast (roasted chicken).

One of KFC's most aggressive strategies was the introduction of its Neighborhood Program. By mid-1993, almost 500 company-owned restaurants in New York, Chicago, Philadelphia, Washington, D.C., St. Louis, Los Angeles, Houston, and Dallas had been outfitted with special menu offerings to appeal exclusively to the black community. Menus were beefed up with side dishes such as greens, macaroni and cheese, peach cobbler, sweet-potato pie, and red beans and rice. In addition, restaurant employees wore African-inspired uniforms. The introduction of the Neighborhood Program increased sales by 5 to 30 percent in restaurants appealing directly to the black community. KFC followed by testing Hispanic-oriented restaurants in the Miami area, offering side dishes such as fried plantains, flan, and tres leches.

One of KFC's most significant problems in the U.S. market was that overcapacity made expansion of free-standing restaurants difficult. Fewer sites were available for new construction, and those sites, because of their increased cost, were driving profit margins down. Therefore, KFC initiated a new three-pronged distribution strategy. First, it focused on building smaller restaurants in nontraditional outlets such as airports, shopping malls, universities, and hospitals. Second, it experimented with home delivery. Home delivery was introduced in the Nashville and Albuquerque markets in 1994. By 1998, home delivery was offered in 365 U.S. restaurants. Other nontraditional distribution outlets being tested included units offering drive-thru and carry-out service only, snack shops in cafeterias, scaled-down outlets for supermarkets, and mobile units that could be transported to outdoor concerts and fairs.

A third focus of KFC's distribution strategy was restaurant cobranding, primarily with its sister chain, Taco Bell. By 1997, 349 KFC restaurants had added Taco Bell to their menus and displayed both the KFC and Taco Bell logos outside their restaurants. Cobranding gave KFC the opportunity to expand its business dayparts. While about two-thirds of KFC's business was dinner, Taco Bell's primary business occurred at lunch. By combining the two concepts in the same unit, sales at individual

restaurants could be increased significantly. KFC believed that there were opportunities to sell the Taco Bell concept in over 3900 of its U.S. restaurants.

Operating Efficiencies

As pressure continued to build on fast-food chains to limit price increases, restaurant chains searched for ways to reduce overhead and other operating costs in order to improve profit margins. In 1989, KFC reorganized its U.S. operations to eliminate overhead costs and increase efficiency. Included in this reorganization was a revision of KFC's crew training programs and operating standards. A renewed emphasis was placed on improving customer service, cleaner restaurants, faster and friendlier service, and continued high-quality products. In 1992, KFC reorganized its middle-management ranks, eliminating 250 of the 1500 management positions at KFC's corporate headquarters. More responsibility was assigned to restaurant franchisees and marketing managers and pay was more closely aligned with customer service and restaurant performance. In 1997, Tricon Global signed a 5-year agreement with PepsiCo Food Systems (which was later sold by PepsiCo to AmeriServe Food Distributors) to distribute food and supplies to Tricon's 29,712 KFC, Pizza Hut, and Taco Bell units. This provided KFC with significant opportunities to benefit from economies of scale in distribution.

INTERNATIONAL OPERATIONS

Much of the early success of the top 10 fast-food chains was the result of aggressive building strategies. Chains were able to discourage competition by building in low-population areas that could only support a single fast-food chain. McDonald's was particularly successful because it was able to quickly expand into small towns across the United States, thereby preempting other fast-food chains. It was equally important to beat a competitor into more largely populated areas where location was of prime importance. KFC's early entry into international markets placed it in a strong position to benefit from international expansion as the U.S. market became saturated. In 1997, 50 percent of KFC's restaurants were located outside the United

States. While 364 new restaurants were opened outside the United States in 1997, only 12 new restaurants were added to the U.S. system. Most of KFC's international expansion was through franchises, although some restaurants were licensed to operators or jointly operated with a local partner. Expansion through franchising was an important strategy for penetrating international markets because franchises were owned and operated by local entrepreneurs with a deeper understanding of local language, culture, and customs, as well as local law, financial markets, and marketing characteristics. Franchising was particularly important for expansion into smaller countries such as the Dominican Republic, Grenada, Bermuda, and Suriname, which could only support a single restaurant. Costs were prohibitively high for KFC to operate company-owned restaurants in these smaller markets. Of the 5117 KFC restaurants located outside the United States in 1997, 68 percent were franchised, while 22 percent were company-owned, and 10 percent were licensed restaurants or joint ventures.

In larger markets such as Japan, China, and Mexico, there was a stronger emphasis on building company-owned restaurants. By coordinating purchasing, recruiting and training, financing, and advertising, fixed costs could be spread over a large number of restaurants, and lower prices on products and services could be negotiated. KFC also was better able to control product and service quality. In order to take advantage of economies of scale, Tricon Global Restaurants managed all the international units of its KFC, Pizza Hut, and Taco Bell chains through its Tricon International Division located in Dallas, Texas. This enabled Tricon Global Restaurants to leverage its strong advertising expertise, international experience, and restaurant management experience across all its KFC, Pizza Hut, and Taco Bell restaurants.

Latin-American Strategy

KFC's primary market presence in Latin America during the 1980s was in Mexico, Puerto Rico, and the Caribbean. KFC established subsidiaries in Mexico and Puerto Rico, from which it coordinated the construction and operation of company-owned restaurants. A third subsidiary in Venezuela was closed because of the high fixed costs associated with running the small subsidiary. Franchises were

used to penetrate other countries in the Caribbean whose market size prevented KFC from profitably operating company restaurants. KFC relied exclusively on the operation of company-owned restaurants in Mexico through 1989. While franchising was popular in the United States, it was virtually unknown in Mexico until 1990, mainly because of the absence of a law protecting patents, information, and technology transferred to the Mexican franchise. In addition, royalties were limited. As a result, most fast-food chains opted to invest in Mexico using company-owned units.

In 1990, Mexico enacted a new law that provided for the protection of technology transferred into Mexico. Under the new legislation, the franchisor and franchisee were free to set their own terms. Royalties also were allowed under the new law. Royalties were taxed at a 15 percent rate on technology assistance and knowhow and 35 percent for other royalty categories. The advent of the new franchise law resulted in an explosion of franchises in fast-food, services, hotels, and retail outlets. In 1992, franchises had an estimated \$750 million in sales in over 1200 outlets throughout Mexico. Prior to passage of Mexico's franchise law, KFC limited its Mexican operations primarily to Mexico City, Guadalajara, and Monterrey. This enabled KFC to better coordinate operations and minimize costs of distribution to individual restaurants. The new franchise law gave KFC and other fast-food chains the opportunity to expand their restaurant bases more quickly into more rural regions of Mexico, where responsibility for management could be handled by local franchisees.

After 1990, KFC altered its Latin American strategy in a number of ways. First, it opened 29 franchises in Mexico to complement its company-owned restaurant base. It then expanded its company-owned restaurants into the Virgin Islands and reestablished a subsidiary in Venezuela. Third, it expanded its franchise operations into South America. In 1990, a franchise was opened in Chile, and in 1993, a franchise was opened in Brazil. Franchises were subsequently established in Colombia, Ecuador, Panama, and Peru, among other South American countries. A fourth subsidiary was established in Brazil, in order to develop company-owned restaurants. Brazil was Latin America's largest economy and McDonald's primary Latin American investment location. By June 1998, KFC operated 438 restaurants in 32 Latin American

countries. By comparison, McDonald's operated 1091 restaurants in 28 countries in Latin America.

Exhibit G shows the Latin American operations of KFC and McDonald's. KFC's early entry into Latin America during the 1970s gave it a leadership position in Mexico and the Caribbean. It also had gained an edge in Ecuador and Peru, countries where McDonald's had not yet developed a strong presence. McDonald's focused its Latin American investment in Brazil, Argentina, and Uruguay, countries where KFC had little or no presence. McDonald's also was strong in Venezuela. Both KFC and McDonald's were strong in Chile, Colombia, Panama, and Puerto Rico.

Economic Environment and the Mexican Market

Mexico was KFC's strongest market in Latin America. While McDonald's had aggressively established restaurants in Mexico since 1990, KFC retained the leading market share. Because of its close proximity to the United States, Mexico was an attractive location for U.S. trade and investment. Mexico's population of 98 million people was approximately one-third as large as the United States and represented a large market for U.S. companies. In comparison, Canada's population of 30.3 million people was only one-third as large as Mexico's. Mexico's close proximity to the United States meant that transportation costs between the United States and Mexico were significantly lower than to Europe or Asia. This increased the competitiveness of U.S. goods in comparison with European and Asian goods, which had to be transported to Mexico across the Atlantic or Pacific Ocean at substantial cost. The United States was, in fact, Mexico's largest trading partner. Over 75 percent of Mexico's imports came from the United States, while 84 percent of its exports were to the United States (see Exhibit H). Many U.S. firms invested in Mexico in order to take advantage of lower wage rates. By producing goods in Mexico, U.S. goods could be shipped back into the United States for sale or shipped to third markets at lower cost.

While the U.S. market was critically important to Mexico, Mexico still represented a small percentage of overall U.S. trade and investment. Since the early 1900s, the portion of U.S. exports to Latin America had declined. Instead, U.S. exports to Canada and Asia, where economic growth out-

EXHIBIT G

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Latin American Restaurant Count: KFC and McDonald's (as of December 31, 1997)

	KFC Company Restaurants	KFC Franchised Restaurants	KFC Total Restaurants	McDonald's
Argentina	—	—	—	131
Bahamas	—	10	10	3
Barbados	—	7	7	—
Brazil	6	2	8	480
Chile	—	29	29	27
Columbia	—	19	19	18
Costa Rica	—	5	5	19
Ecuador	—	18	18	2
Jamaica	—	17	17	7
Mexico	128	29	157	131
Panama	—	21	21	20
Peru	—	17	17	5
Puerto Rico & Virgin Islands	67	—	67	115
Trinidad & Tobago	—	27	27	3
Uruguay	—	—	—	18
Venezuela	6	—	6	53
Other	—	30	30	59
Total	207	231	438	1,091

Source: Tricon Global Restaurants, Inc.; McDonald's, 1997 Annual Report.

EXHIBIT H

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Mexico's Major Trading Partners—% Total Exports and Imports

	1992		1994		1996	
	Exports	Imports	Exports	Imports	Exports	Imports
U.S.	81.1	71.3	85.3	71.8	84.0	75.6
Japan	1.7	4.9	1.6	4.8	1.4	4.4
Germany	1.1	4.0	0.6	3.9	0.7	3.5
Canada	2.2	1.7	2.4	2.0	1.2	1.9
Italy	0.3	1.6	0.1	1.3	1.2	1.1
Brazil	0.9	1.8	0.6	1.5	0.9	0.8
Spain	2.7	1.4	1.4	1.7	1.0	0.7
Other	10.0	13.3	8.0	13.0	9.6	12.0
% Total	100.0	100.0	100.0	100.0	100.0	100.0
Value (\$M)	46,196	62,129	60,882	79,346	95,991	89,464

Source: International Monetary Fund, *Direction of Trade Statistics Yearbook*, 1997.

paced growth in Mexico, increased more quickly. Canada was the largest importer of U.S. goods. Japan was the largest exporter of goods to the United States, with Canada a close second. U.S. investment in Mexico also was small, mainly because of past government restrictions on foreign investment. Most U.S. foreign investment was in Europe, Canada, and Asia.

The lack of U.S. investment in and trade with Mexico during this century was mainly the result of Mexico's long history of restricting trade and foreign direct investment. The Institutional Revolutionary Party (PRI), which came to power in Mexico during the 1930s, had historically pursued protectionist economic policies in order to shield Mexico's economy from foreign competition. Many industries were government-owned or controlled, and many Mexican companies focused on producing goods for the domestic market without much attention to building export markets. High tariffs and other trade barriers restricted imports into Mexico, and foreign ownership of assets in Mexico was largely prohibited or heavily restricted.

Additionally, a dictatorial and entrenched government bureaucracy, corrupt labor unions, and a long tradition of anti-Americanism among many government officials and intellectuals reduced the motivation of U.S. firms for investing in Mexico. The nationalization of Mexico's banks in 1982 led to higher real interest rates and lower investor confidence. Afterward, the Mexican government battled high inflation, high interest rates, labor unrest, and lost consumer purchasing power. Investor confidence in Mexico, however, improved after 1988, when Carlos Salinas de Gortari was elected president. Following his election, Salinas embarked on an ambitious restructuring of the Mexican economy. He initiated policies to strengthen the free-market components of the economy, lowered top marginal tax rates to 36 percent (down from 60 percent in 1986), and eliminated many restrictions on foreign investment. Foreign firms can now buy up to 100 percent of the equity in many Mexican firms. Foreign ownership of Mexican firms was previously limited to 49 percent.

Privatization

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The privatization of government-owned companies came to symbolize the restructuring of Mexico's economy. In 1990, legislation was passed to priva-

tize all government-run banks. By the end of 1992, over 800 of some 1200 government-owned companies had been sold, including Mexicana and AeroMexico, the two largest airline companies in Mexico, and Mexico's 18 major banks. However, more than 350 companies remained under government ownership. These represented a significant portion of the assets owned by the state at the start of 1988. Therefore, the sale of government-owned companies, in terms of asset value, was moderate. A large percentage of the remaining government-owned assets were controlled by government-run companies in certain strategic industries such as steel, electricity, and petroleum. These industries had long been protected by government ownership. As a result, additional privatization of government-owned enterprises until 1993 was limited. However, in 1993, President Salinas opened up the electricity sector to independent power producers, and Petroleos Mexicanos (Pemex), the state-run petrochemical monopoly, initiated a program to sell off many of its nonstrategic assets to private and foreign buyers.

North American Free Trade Agreement (NAFTA)

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Prior to 1989, Mexico levied high tariffs on most imported goods. In addition, many other goods were subjected to quotas, licensing requirements, and other nontariff trade barriers. In 1986, Mexico joined the General Agreement on Tariffs and Trade (GATT), a world trade organization designed to eliminate barriers to trade among member nations. As a member of GATT, Mexico was obligated to apply its system of tariffs to all member nations equally. As a result of its membership in GATT, Mexico dropped tariff rates on a variety of imported goods. In addition, import license requirements were dropped for all but 300 imported items. During President Salinas' administration, tariffs were reduced from an average of 100 percent on most items to an average of 11 percent.

On January 1, 1994, the North American Free Trade Agreement (NAFTA) went into effect. The passage of NAFTA, which included Canada, the United States, and Mexico, created a trading bloc with a larger population and gross domestic product than the European Union. All tariffs on goods traded among the three countries were scheduled to be phased out. NAFTA was expected to be par-

ticularly beneficial for Mexican exporters because reduced tariffs made their goods more competitive in the United States compared with goods exported to the United States from other countries. In 1995, one year after NAFTA went into effect, Mexico posted its first balance of trade surplus in 6 years. Part of this surplus was attributed to reduced tariffs resulting from the NAFTA agreement. However, the peso crisis of 1995, which lowered the value of the peso against the dollar, increased the price of goods imported into Mexico and lowered the price of Mexican products exported to the United States. Therefore, it was still too early to assess the full effects of the NAFTA agreement. (See Exhibit I for further details.)

Foreign Exchange and the Mexican Peso Crisis of 1995

Between 1982 and 1991, a two-tiered exchange-rate system was in force in Mexico. The system consisted of a controlled rate and a free-market rate. A controlled rate was used for imports, foreign debt payments, and conversion of export proceeds. An estimated 70 percent of all foreign transactions were covered by the controlled rate. A free-market

rate was used for other transactions. In 1989, President Salinas instituted a policy of allowing the peso to depreciate against the dollar by one peso per day. The result was a grossly overvalued peso. This lowered the price of imports and led to an increase in imports of over 23 percent in 1989. At the same time, Mexican exports became less competitive on world markets.

In 1991, the controlled rate was abolished and replaced with an official free rate. In order to limit the range of fluctuations in the value of the peso, the government fixed the rate at which it would buy or sell pesos. A floor (the maximum price at which pesos could be purchased) was established at Ps 3056.20 and remained fixed. A ceiling (the maximum price at which the peso could be sold) was established at Ps 3056.40 and allowed to move upward by Ps 0.20 per day. This was later revised to Ps 0.40 per day. In 1993, a new currency, called the *new peso*, was issued with three fewer zeros. The new currency was designed to simplify transactions and to reduce the cost of printing currency.

When Ernesto Zedillo became Mexico's president in December 1994, one of his objectives was to continue the stability of prices, wages, and exchange rates achieved by ex-President Carlos

EXHIBIT I

Selected Economic Data for Canada, the United States, and Mexico

Annual Change (%)	1993	1994	1995	1996	1997
GDP growth					
Canada	3.3	4.8	5.5	4.1	—
United States	4.9	5.8	4.8	5.1	5.9
Mexico	21.4	13.3	29.4	38.2	—
Real GDP growth					
Canada	2.2	4.1	2.3	1.2	—
United States	2.2	3.5	2.0	2.8	3.8
Mexico	2.0	4.5	-6.2	5.1	—
Inflation					
Canada	1.9	0.2	2.2	1.5	1.6
United States	3.0	2.5	2.8	2.9	2.4
Mexico	9.7	6.9	35.0	34.4	20.6
Depreciation against \$U.S.					
Canada (C\$)	4.2	6.0	-2.7	0.3	4.3
Mexico (NP)	-0.3	71.4	43.5	2.7	3.6

Source: International Monetary Fund, *International Financial Statistics*, 1998.

Salinas de Gortari during his 5-year tenure as president. However, Salinas had achieved stability largely on the basis of price, wage, and foreign-exchange controls. While giving the appearance of stability, an overvalued peso continued to encourage imports, which exacerbated Mexico's balance of trade deficit. Mexico's government continued to use foreign reserves to finance its balance of trade deficits. According to the Banco de Mexico, foreign currency reserves fell from \$24 billion in January 1994 to \$5.5 billion in January 1995. Anticipating a devaluation of the peso, investors began to move capital into U.S. dollar investments. In order to relieve pressure on the peso, Zedillo announced on December 19, 1994 that the peso would be allowed to depreciate by an additional 15 percent per year against the dollar compared with the maximum allowable depreciation of 4 percent per year established during the Salinas administration. Within 2 days, continued pressure on the peso forced Zedillo to allow the peso to float freely against the dollar. By mid-January 1995, the peso had lost 35 percent of its value against the dollar, and the Mexican stock market plunged 20 percent. By November 1995, the peso had depreciated from 3.1 pesos per dollar to 7.3 pesos per dollar.

The continued devaluation of the peso resulted in higher import prices, higher inflation, destabilization within the stock market, and higher interest rates. Mexico struggled to pay its dollar-based debts. In order to thwart a possible default by Mexico, the U.S. government, International Monetary Fund, and World Bank pledged \$24.9 billion in emergency loans. Zedillo then announced an emergency economic package called the *pacto* that included reduced government spending, increased sales of government-run businesses, and a freeze on wage increases.

Labor Problems

One of KFC's primary concerns in Mexico was the stability of labor markets. Labor was relatively plentiful, and wages were low. However, much of the workforce was relatively unskilled. KFC benefited from lower labor costs, but labor unrest, low job retention, high absenteeism, and poor punctuality were significant problems. Absenteeism and punctuality were partially cultural. However, problems with worker retention and labor unrest also were the result of workers' frustration over the loss of

their purchasing power due to inflation and government controls on wage increases. Absenteeism remained high at approximately 8 to 14 percent of the labor force, though it was declining because of job security fears. Turnover continued to be a problem and ran at between 5 and 12 percent per month. Therefore, employee screening and internal training were important issues for firms investing in Mexico.

Higher inflation and the government's freeze on wage increases led to a dramatic decline in disposable income after 1994. Further, a slowdown in business activity, brought about by higher interest rates and lower government spending, led many businesses to lay off workers. By the end of 1995, an estimated 1 million jobs had been lost as a result of the economic crisis sparked by the peso devaluation. As a result, industry groups within Mexico called for new labor laws giving them more freedom to hire and fire employees and increased flexibility to hire part-time rather than full-time workers.

RISKS AND OPPORTUNITIES

The peso crisis of 1995 and resulting recession in Mexico left KFC managers with a great deal of uncertainty regarding Mexico's economic and political future. KFC had benefited from economic stability between 1988 and 1994. Inflation was brought down, the peso was relatively stable, labor unrest was relatively calm, and Mexico's new franchise law had enabled KFC to expand into rural areas using franchises rather than company-owned restaurants. By the end of 1995, KFC had built 29 franchises in Mexico. The foreign-exchange crisis of 1995 had severe implications for U.S. firms operating in Mexico. The devaluation of the peso resulted in higher inflation and capital flight out of Mexico. Capital flight reduced the supply of capital and led to higher interest rates. In order to reduce inflation, Mexico's government instituted an austerity program that resulted in lower disposable income, higher unemployment, and lower demand for products and services.

Another problem was Mexico's failure to reduce restrictions on U.S. and Canadian investment in a timely fashion. Many U.S. firms experienced problems getting required approvals for new ventures from the Mexican government. A good example was United Parcel Service (UPS), which sought

government approval to use large trucks for deliveries in Mexico. Approvals were delayed, forcing UPS to use smaller trucks. This put UPS at a competitive disadvantage vis-à-vis Mexican companies. In many cases, UPS was forced to subcontract delivery work to Mexican companies that were allowed to use larger, more cost-efficient trucks. Other U.S. companies such as Bell Atlantic and TRW faced similar problems. TRW, which signed a joint-venture agreement with a Mexican partner, had to wait 15 months longer than anticipated before the Mexican government released rules on how it could receive credit data from banks. TRW claimed that the Mexican government slowed the approval process in order to placate several large Mexican banks.

A final area of concern for KFC was increased political turmoil in Mexico during the last several years. On January 1, 1994, the day NAFTA went into effect, rebels (descendants of the Mayans) rioted in the southern Mexican province of Chiapas on the Guatemalan border. After 4 days of fighting, Mexican troops had driven the rebels out of several towns earlier seized by the rebels. Around 150—mostly rebels—were killed. The uprising symbolized many of the fears of the poor in Mexico. While ex-President Salinas' economic programs had increased economic growth and wealth in Mexico, many of Mexico's poorest felt that they had not benefited. Many of Mexico's farmers, faced with lower tariffs on imported agricultural goods from the United States, felt that they might be driven out of business because of lower-priced imports. Therefore, social unrest among Mexico's Indians, farmers, and the poor could potentially unravel much of the economic success achieved in Mexico during the last 5 years.

Further, ex-President Salinas' hand-picked successor for president was assassinated in early 1994

while campaigning in Tijuana. The assassin was a 23-year-old mechanic and migrant worker believed to be affiliated with a dissident group upset with the PRI's economic reforms. The possible existence of a dissident group raised fears of political violence in the future. The PRI quickly named Ernesto Zedillo, a 42-year-old economist with little political experience, as their new presidential candidate. Zedillo was elected president in December 1994. Political unrest was not limited to Mexican officials and companies. In October 1994, between 30 and 40 masked men attacked a McDonald's restaurant in the tourist section of Mexico City to show their opposition to California's Proposition 187, which would have curtailed benefits to illegal aliens (primarily from Mexico). The men threw cash registers to the floor, cracked them open, smashed windows, overturned tables, and spray-painted slogans on the walls such as "No to Fascism" and "Yankee Go Home."

KFC faced a variety of issues in Mexico and Latin America in 1998. Prior to 1995, few restaurants had been opened in South America. However, KFC was now aggressively building new restaurants in the region. KFC halted openings of franchised restaurants in Mexico, and all restaurants opened since 1995 were company-owned. KFC was more aggressively building restaurants in South America, which remained largely unpenetrated by KFC through 1995. Of greatest importance was Brazil, where McDonald's had already established a strong market-share position. Brazil was Latin America's largest economy and a largely untapped market for KFC. The danger in ignoring Mexico was that a conservative investment strategy could jeopardize its market-share lead over McDonald's in a large market where KFC long enjoyed enormous popularity.