PIZZA HUT, INC.

In May 1986, Steve Reinemund, the newly appointed president of Pizza Hut, Inc., announced that he intended to pursue vigorously the "exciting opportunities afforded by our new segment, delivery." Seven months later, the home delivery units had produced mixed results, and Reinemund met with his senior managers to decide how to respond.

Entry into the home delivery market had been a major strategic decision at Pizza Hut, and Reinemund was well aware of the difficulties it presented. Half of the 5,025 Pizza Hut system restaurants were owned by large, powerful franchisees with exclusive rights to the territories they controlled. While some franchisees saw the benefits of home delivery in their markets, others were strongly opposed. Moreover, many franchisees did not agree with the manner in which Pizza Hut would implement delivery. Nevertheless, to be successful, the delivery strategy needed the franchisees' cooperation. Attaining this cooperation in the Pizza Hut franchise system would be, in the words of Jim Baxter, vice president of franchising, "a matter of *sell,* not *tell.*"

The Pizza Market

The rapid growth in home delivery in the mid-1980s revitalized the pizza market and was responsible for pizza's position as the fastest-growing part of the $53 billion fast food market. Three main segments comprised the pizza restaurant market: eat-in, carryout, and delivery. The sales for each segment are shown below:

	Eat-In	Carryout	Delivery	Total
1982	$4.3 billion (57%)	$3.1 billion (41%)	$0.1 billion (1%)	$ 7.5 billion
1984	$4.7 billion (48%)	$4.0 billion (41%)	$1.0 billion (10%)	$ 9.7 billion
1986[a]	$5.1 billion (40%)	$5.0 billion (39%)	$2.6 billion (20%)	$12.7 billion
1990[a]	$5.9 billion (27%)	$9.0 billion (41%)	$7.0 billion (32%)	$21.9 billion

Source: GDR/Crest Enterprises, Inc.

[a]Projections based on limited Pizza Hut entry into delivery segment as of third-quarter 1986

Many companies competed in more than one segment; for example, carryout was a significant percentage of most eat-in restaurants' business. At Pizza Hut, carryout accounted for 40% of the dollar volume in 1986, compared with 37% in 1982.

In 1986, while the overall pizza market expanded rapidly (because of home delivery), in-restaurant consumption of pizza was not increasing significantly. Industry observers believed that the restaurant industry was seriously overbuilt; pizza parlors seemed to be on every corner in some towns. They believed that the already intense local competition in the pizza eat-in and carryout segments would soon approach all-out warfare, as evidenced by increased use of couponing, deals, and price competition.

The Pizza Consumer

Pizza was a very popular restaurant food item, second only to hamburgers in frequency of purchase. Pizza was predominantly a dinner food, although many consumers also viewed it as an evening snack. Consumers did not react casually to pizza, unlike their feelings for hamburgers, chicken, and fish. Consumer research had shown that pizza was a personal, almost sensual, experience for many people. Moreover, consumers generally did not believe that great pizza could be made by a fast-food chain.

Professor Patrick J. Kaufmann prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Proprietary data have been disguised.

While pizza consumption was strongest in the northern and eastern parts of the United States, pizza's appeal was broad based, with no areas exhibiting major rejection. However, tastes in pizza varied significantly by region. This presented a challenge for chains attempting to maintain product continuity while expanding into different regions.

By the early 1980s, convenience was crucial to many consumers. Two-career families often found cooking at home or eating in restaurants too time consuming, thereby increasing carryout and home delivery business. In both 1985 and 1986, consumer surveys undertaken by the *National Restaurant Association* identified pizza home delivery as the most important new fast food concept. Another study had shown that consumers generally viewed pizza as eat-at-home food. Many analysts believed that the rapid growth of the in-home video rental market, together with the increasing number of baby-boomers with small children, would further fuel the pizza delivery segment.

Competition in the Pizza Market

Although faced with intense competition from aggressive regional chains and single-unit owner-operated local competitors, Pizza Hut had dominated the eat-in pizza segment nationwide for years (Exhibit 1). Godfather's Pizza, another eat-in/carryout chain, which competed in many of the same local markets as Pizza Hut, traditionally was perceived as Pizza Hut's most significant national competitor.

Before 1984, neither Pizza Hut nor its franchisees thought that Domino's Pizza posed a serious competitive threat to Pizza Hut's leadership position in the overall pizza market. Domino's, however, had grown from sales of $626 million in 1984 to $1.085 billion in 1985, and to $1.55 billion by the end of 1986. In 1985 the chain opened 954 new outlets (bringing the total to 2,839)—the highest one-year total ever recorded by a food service company. Two-thirds of Domino's outlets were franchised; the company used its company-owned stores as sites for required franchisee training. Although there were several large franchisees operating many units all over the United States, most of the 600 franchisees in early 1986 owned only one or two stores. While some of its outlets had carryout windows, Domino's was essentially a delivery-only chain. Domino's management believed the large percentage of carryout business in the industry was especially vulnerable to Domino's delivery strategy.

Pizza Hut first experienced the effects of Domino's expansion in its company-owned stores. While Pizza Hut's franchisees had exclusive rights to most of the smaller markets, Pizza Hut's company-owned stores controlled most of the large, densely populated metropolitan markets. Domino's had initially focused its national expansion on those large metropolitan markets. By late 1985, Pizza Hut senior management was convinced that Domino's dominance of the fast-growing delivery segment was the major threat to Pizza Hut's continued leadership of the overall pizza market. By 1986, Domino's had begun to extend its expansion into the smaller towns generally controlled by Pizza Hut franchisees. Domino's clearly intended to gain total market leadership while maintaining its dominance of the delivery segment.

Pizza Hut, Incorporated

On June 15, 1958, Dan and Frank Carney, two college students from Wichita, Kansas, opened the first Pizza Hut restaurant. It was a startling success. By the following February, the Carney brothers had opened two more restaurants and had begun to develop plans for the first franchised outlet. The chain grew rapidly, with 43 restaurants opened by 1963 and 296 by 1968. Pizza Hut went public in 1969, and in 1977 was acquired by PepsiCo, Inc. In 1981 Pizza Hut became the largest pizza restaurant chain in the world in both sales and number of restaurants. Sales reached $1 billion in 1981; by December 1986, Pizza Hut, still headquartered in Wichita, had a total of 5,025 domestic units and annual sales of almost $2 billion (Exhibit 2).

Since the 1960s, Pizza Hut restaurants were characterized by a distinctive freestanding design and familiar red roof (Exhibit 3). All Pizza Hut restaurants were full-service, eat-in/carryout family-style operations seating about 60 to 90 customers and normally open from 11 a.m. to midnight.

Although the menu had changed over the years, pizza was always the main product in Pizza Hut restaurants. The company paid careful attention to operational efficiency, and continued to offer a high-quality product at a premium price. A constant stream of new product introductions served to invigorate consumer interest, but many franchisees were concerned by the increased cost of operations caused by the expanding menu.

For more than 20 years, the Pizza Hut franchisees had taken the lead in marketing. In the early 1980s, however, the company further strengthened its corporate marketing department and began developing comprehensive national and local market strategies. By 1986, the company was developing and implementing systemwide corporate marketing programs and realizing leverage from national TV advertising.

The Franchise System at Pizza Hut

Franchising was an integral part of the Pizza Hut strategy since the corporation's founding. In 1968, there were 293 franchised restaurants and only seven company-owned restaurants. Over the next seven years, the company built new stores and acquired many more (including the acquisition of the 225 units of a large Pizza Hut franchisee). By the mid-1970s, there were almost as many company-owned as franchised units. In December 1986, 135 individuals, partnerships, and/or corporations operated 2,395 Pizza Hut system restaurants and 96 delivery-only units as franchisees. Meanwhile, the company itself operated 2,173 restaurants and 361 delivery-only units.

Many of the original franchisees, whose holdings had grown with the company, were still part of the system in 1986. Sixty percent of all franchised units were controlled by franchisees whose main offices were still in Wichita. In the Pizza Hut system, exclusive franchises were granted for specified market areas. Unlike franchise systems characterized by single-unit owner/operators, most Pizza Hut franchisees were large companies with diversified holdings, sometimes including other food service franchisor units like Kentucky Fried Chicken and Long John Silver. Of the 135 franchisees, almost two-thirds operated 10 or more Pizza Hut system restaurants in 1986. Except for minority opportunity programs, no new franchise areas had been offered to the public since 1971. When a franchisee chose to sell its holdings, they were purchased by the company or another franchise holder.

Franchisee rights and obligations were specified in formal franchise agreements. Under the agreements, each franchisee was obligated to develop its exclusive market area in accordance with a five-year development schedule. Essentially, the agreement required the franchisee to open an agreed-upon number of new restaurants during the first year of the agreement, an agreed-upon number during the second year, and so on, up to year five. The development schedule represented franchisee commitment to significant continuing investment in the business. After the five-year period expired, the company could negotiate a secondary development schedule with the franchisee to open additional restaurants in the area, if the company deemed it practicable. Although franchisee failure to comply with either development schedule entitled the company to franchise others or to open company-owned restaurants in the previously exclusive area, this had never been necessary. In no case could there be a restaurant established within two miles of an existing franchisee restaurant.

Franchisees paid Pizza Hut an initial fee of $15,000 for each system restaurant they opened. Franchisees also paid the company an ongoing franchise fee of 4% of monthly gross sales. The company or franchisee invested about $466,000–$816,000 to open each eat-in/carryout restaurant. By contrast, delivery-only units required an estimated $128,500–$198,500 investment. However, by the time one included delivery vehicles, training, additional advertising, and the company's central order-taking computer system, the company's investment in a company-owned delivery unit was about equal to that of a traditional restaurant. Franchisees investing in delivery-only units typically did not buy vehicles and did not always adopt the company's computer-ordering system (see Exhibit 4 for expenses of company-owned delivery units).

The International Pizza Hut Franchise Holders Association

The International Pizza Hut Franchise Holders Association (IPHFHA) was formed in 1967 to "solidify the national image of Pizza Hut and to further product loyalty," and to "devise the most appropriate use of the funds available for national advertising." By 1986, its role had been extended to render many other services to franchisees (e.g., accounting services, group life insurance, workman's compensation insurance, credit union).

Franchisees were required to become members of the IPHFHA. The IPHFHA communicated with the company regularly through the IPHFHA board of directors. The IPHFHA employed a professional staff headed by Gerald Aaron, president, who acted as intermediary between the board and the company. He directed for the association the broad policy areas of marketing, finance, and administration. Joint advisory committees (with franchisee and company members) were formed in 1985 to further enhance communication between the company and the franchisees on the issues of human resources, delivery, products, and buildings and equipment.

The IPHFHA was reorganized in 1975, and the Advertising Committee was formed to "determine and control the amount, kind, and quality of national advertising and sales promotion to be provided . . . for Pizza Hut and its franchisees." (In 1981 the role of the Advertising Committee was continued under the new franchise agreement.) Four marketing professionals made up the Advertising Committee, two representing the company and two representing the franchisees. IPHFHA Members voted on funding for national advertising and other IPHFHA programs. The company, although not a member of IPHFHA, was contractually bound by the franchise agreement to contribute at the same rate as the franchisees. In 1986, the current assessment was 2% of the first $28,000 of monthly sales for each restaurant and 1% of all monthly sales above $28,000. The Advertising Committee controlled the entire advertising budget, and was also responsible for hiring and firing the national advertising agency.

Market area advertising was managed by local co-ops comprising all of those franchisees (and the company if applicable) operating restaurants within a particular market area. All co-op members, franchisees and company alike, were required to make contributions to the co-op for advertising in their area in the amount of 2% of monthly gross sales (in addition to the contributions to the national advertising fund). All disputes arising within co-ops were arbitrated by the Advertising Committee.

In addition to ad hoc interaction between the company and its franchisees at regional store manager meetings, there were two general systemwide meetings each year. Franchisees set the summer meeting agenda and the company set the winter meeting agenda. Company management also regularly met with the board of IPHFHA and with the franchisees on the advisory committees.

Delivery at Pizza Hut, Inc.

For many years, the prospect of entering the delivery market worried Pizza Hut senior managers; delivery units might cannibalize the traditional restaurant business, causing reduced profit margins. In the summer of 1984, however, Pizza Hut began exploring the possibility of such an entry. Because it was believed that the addition of delivery service to traditional eat-in restaurants would create unmanageable operational bottlenecks, the solution for Pizza Hut management was to enter the delivery market with separate delivery-only units (i.e., with no eat-in or carryout facilities). These units would be considerably smaller than the traditional restaurant facilities and would not require parking space or highly visible locations (Exhibit 3); occupancy costs therefore would be about 2.1% of sales rather than 6% for the standard eat-in restaurants.

In 1985 a small delivery task group was formed at Pizza Hut and began opening company-owned delivery units in several markets. Their idea was to open a cluster of delivery-only units in each market and keep their costs as low as possible because of the small expected margins (Exhibit 4). There was considerable resistance to the delivery concept at all levels within the company, and company restaurant managers and supervisors in the markets where delivery units had been opened complained bitterly about the adverse effect on their sales. Nevertheless, Pizza Hut management was becoming increasingly concerned about Domino's rapid expansion, and deemed entry into the delivery segment necessary if the company was to maintain its market leadership position.

By August 1985, eight markets had been opened with a total of 51 company-owned delivery-only units. In the well-developed markets—Atlanta, Georgia, and Norfolk, Virginia—customers called a single phone number. Orders were then sent by facsimile machine to the appropriate delivery unit. Although the system was relatively cheap, as the number of units grew, it became more and more unmanageable, and the "fax" machines presented a significant bottleneck. In late summer 1985, senior Pizza Hut managers visited the Norfolk market and became convinced that, with a number of operational adjustments, the delivery concept was workable, offered tremendous potential growth, and should be pursued. The company postponed further expansion into new markets while it contracted for the development of a computerized central ordering system and perfected other aspects of the delivery concept.

The computerized central ordering system, called the Customer Service Center (CSC), allowed customers in a particular market to call a single number to place an order. The caller first was asked his or her phone number and the system ascertained whether the caller had ordered before. If so, the operator would verify the caller's name and address and ask if the customer would like the same type of pizza previously ordered. The order would then be forwarded automatically to the appropriate delivery unit where a terminal would receive the order information.

The CSC system, although expensive to develop, was designed to be capable of handling the vast number of calls generated in a large market with a large number of delivery units. It was necessary, however, that the system work perfectly. Customers in an eat-in restaurant understood and tolerated waiting a few minutes to be seated. Delivery customers expected their phone call to be answered within seconds, even though 60% of the daily calls for an entire market area might come in during a one-hour period. While there were substantial marketing benefits to having only one phone number for an entire market, there were significant risks in operating such a complex system. In Norfolk, Virginia, initial problems with the installation of the CSC had created serious losses in a once-profitable delivery market.

Although there had been some difficulties during its installation, Pizza Hut management was convinced that the CSC would be a significant competitive advantage. About 70% of Domino's franchisees owned only one store, and Pizza Hut believed that the costs of coordination and management of such a centralized ordering system at Domino's would be prohibitive. In the Pizza Hut system, the concentration of restaurant ownership in the hands of the company and relatively few franchisees would allow for much easier coordination and substantial cost savings. Under the company's delivery concept, the company would invest in the CSC for each market and manage it, coordinating the ordering process and providing service on a fee-per-call basis to participating franchisees and company stores (currently $ .65 per call). Pizza Hut's investment in the CSCs was expected to be large, but management believed that such systems were essential to the delivery strategy. It was expected that eventually the franchisees would purchase the necessary equipment and manage the Customer Service Centers themselves in their own markets.

Another major issue presented in developing a profitable delivery concept was whether there would be a charge for service. Pizza Hut management was convinced that for competitive reasons the company could not charge for delivery (Domino's delivered free with a 30-minute guarantee). The additional cost of providing free delivery was the same, regardless of order size. This meant that, to the extent the average check price could be increased, margins would increase. To help maintain margins when offering free delivery, therefore, it was decided that the size and price of delivered pizzas would be slightly increased over pizza in traditional restaurants (i.e., delivery sizes would be 10-14-16″ versus the 9-13-15″ sizes in the traditional restaurants and Domino's 12-16″ sizes). Customers would pay approximately 10% more for a small, medium, or large pizza, but would get more as well. This "upsizing" would increase the average check price and gross margin, thereby helping to defray the cost of free delivery and the Customer Service Centers.

In early 1986, Pizza Hut was reorganized to reflect the increasing importance and autonomy of the delivery segment (Exhibit 5). A senior vice president of operations managed all traditional restaurant operations, while Senior Vice President Allan Huston was general manager of delivery. Still another senior vice president led the marketing function for the traditional restaurants. Delivery had its own separate marketing department that reported directly to Allan Huston. Even the regions into which the country was divided were different for delivery and the traditional restaurant business.

Although there was some experimentation with alternative delivery concepts (e.g., no upsizing in some markets) during the spring and summer of 1986, the marketing function for the delivery group was not fully operational until July. Huston concentrated primarily on the operational details surrounding the opening of new delivery units rather than on refining the Pizza Hut delivery concept. In the first half of 1986, Pizza Hut doubled the number of markets where it operated delivery units and had almost quadrupled the total number of units (Exhibit 6). Those delivery units were predominately in metropolitan areas—where most of the company's markets were. The initial units opened were in markets with high levels of traditional restaurant penetration and high "per-store-average" (PSA) sales. A second group, opened later in 1986, were in low penetration and low per-store-average sales markets.

Throughout 1986, Pizza Hut managers on the traditional restaurant side of the business continued to be concerned about competition from the Pizza Hut delivery operation, as well as from Domino's. Huston and other managers in the delivery operation, however, believed that delivery was expanding the market by including people who would not go to a restaurant for pizza. They argued that consumers who ate pizza in restaurants and those who had pizza delivered sought very different benefits, and that delivery did not compete directly with traditional restaurants. Moreover, the adverse effects of Pizza Hut delivery units on traditional restaurant sales growth appeared to be most pronounced in markets where there was weak sales growth already; in strong markets the effect was short lived. As Reinemund noted in early 1986, "We do not yet know how great a factor this overlap will be. But what we do know is that in many cases our restaurant business has actually grown after our delivery units have entered the market." In the words of another senior Pizza Hut manager:

> While it is true that we often are serving the same customers, we are serving them on totally separate dining occasions. When we introduce delivery to a market, we get the business of customers who probably were ordering a competitor's pizza simply for the convenience of home delivery.

As for personnel, it was clear that needs of the delivery business were significantly different from those of the traditional restaurant business. Pizza Hut restaurant managers were trained to manage the "total customer experience" and, because of the isolation from customers, some restaurant managers did not think they would enjoy running a delivery-only unit. While many production and operation functions would overlap, store managers found it hard to see how career paths could cross over from traditional full-service restaurants to delivery units or vice versa. Moreover, moving as quickly as it had into new markets, Pizza Hut found it difficult to manage at the store level. Ninety percent of the people working in the delivery business were new, and delivery presented unfamiliar operational demands in the areas of driver management, trade area definition, and order taking.

The Franchisees' Experience with Delivery

A few Pizza Hut franchisees had been offering delivery unofficially for 20 years. In the early 1980s, the company consistently attempted to dissuade franchisees from offering delivery. Nevertheless, the number of small-town franchisees delivering pizza to college dormitories and military bases from their traditional restaurants had begun to increase. In some isolated cases franchisees faced local competitive environments that they believed necessitated offering delivery. By 1982, about 25 franchisees operated delivery services from a total of about 75 standard eat-in restaurants.

Most franchisees that entered the delivery segment did so by retrofitting existing eat-in restaurants to allow for delivery "out the back door" (Exhibit 6 shows the number of franchisees owning retrofit and delivery-only units from 1984 to 1986). They found, however, that retrofitting significantly increased demands on the restaurant manager and required much greater local management skills. Because of operational bottlenecks, some franchisees lost money on the delivery business and ceased delivery operations. The company believed this supported its concept of opening separate delivery-only units.

Through 1985, the majority of Pizza Hut franchisees saw no reason for delivery. They faced little or no competition in their market from the major chains offering delivery, and were less interested in overall market share battles than the company seemed to be. Sixty-five percent of all franchised restaurants were in towns with populations under 50,000 people, and delivery in those rural areas was not as easy to justify economically as in more densely populated markets. In late 1985, when the company changed its position completely and began to encourage franchisees to open delivery-only units, most franchisees were not interested in doing so.

In November 1985, the company announced to franchisees that it interpreted franchise agreement development schedules to include delivery and, therefore, the company had the right to require franchisee development of delivery units in their markets. The company announced that it would not exercise that right for one-and-a-half years while it perfected the concept, but urged franchisees to begin developing delivery-only units immediately.

The franchise community's response was quick and clear. Most franchisees saw no reason to risk business in their eat-in restaurants by expanding into the delivery market. They denied that the development schedules allowed Pizza Hut to require them to open delivery units. They openly expressed their disagreement with the company's delivery concept, especially regarding upsizing (referred to by one franchisee as "up-pricing"). They also questioned the necessity of the computerized Customer Service Centers and the delivery-only units (some franchisees wanted to retrofit existing restaurants, and others wanted carryout allowed in the delivery units). Significant tension arose between the company and its franchisees. At a heated IPHFHA board meeting in December 1985, board members and Pizza Hut senior management recognized that they had been concentrating too much on each other and not enough on Domino's. They agreed to operate temporarily under a "yellow flag" plan (an automobile racing term referring to the period when each side continues to operate as before without either side trying to improve its relative position).

The company's upsizing concept continued to be a focal point of disagreement. Although Pizza Hut suggested prices, the franchisees were free to price their products as they pleased. The franchisees argued that, even though they had not increased prices as frequently as the company-owned restaurants had in past years, they were still at a price disadvantage when compared to the competition. This disadvantage was especially acute in the delivery business; franchisees believed that upsizing would exacerbate the problem because customers were conscious only of the absolute price of a small, medium, or large pizza and did not calculate price per square inch of the product.

The franchisees also wanted to know why Pizza Hut needed an expensive CSC system, if Domino's didn't have one. They felt that if delivery was necessary, the costs should be kept as low as possible. This meant simple phone ordering to each local restaurant, and delivery out of existing restaurants where feasible. It was important to franchisees that the system be as flexible as possible so that they could find local solutions to local problems.

The reorganization of Pizza Hut in early 1986, which provided for the delivery business to operate autonomously from the traditional restaurant business, raised another issue in the franchise community. Franchisees were concerned that while the company could afford to run the delivery and eat-in businesses separately, the franchisees did not have the resources for separate marketing and operations departments for the traditional restaurant and delivery business. The mismatch of organizational forms between company and franchisees was expected to create significant management difficulties. To make matters worse, the Pizza Hut national advertising account had been split in two within the advertising agency so that a separate group could begin working only on delivery. Many franchisees viewed the two businesses as one and were concerned that their separation would make coordination between delivery and eat-in even more difficult.

There was little consensus of opinion among the franchisees regarding the various elements of the company's delivery concept. There was, however, virtual unanimous franchisee concurrence that the existing franchise agreement did not cover delivery. In February 1986 Jim Baxter, who had been with Pizza Hut for almost 10 years, was appointed vice president of restaurant franchising and assumed the role of liaison between the company and franchisees. In May, newly appointed president Steve Reinemund accompanied Baxter to a series of regional meetings with the franchisees where Reinemund announced that the company no longer contended that the existing development agreement covered delivery. He also announced the company's intention to negotiate with the board of the IPHFHA to produce an amendment to the franchise agreement that would provide for systemwide entry into the delivery market. Reinemund suggested that the amendment would include incentives (e.g., reduced or no royalties for a certain time period on new delivery-only units) designed to make franchisee participation in the delivery segment more attractive. These incentives would be retroactive for any franchisee delivery-only units opened in the meantime. The amendment would take effect if franchisees representing 85% of the units approved it within a specified time period.

The August Franchisee Meeting

As the August 1986 franchisee meeting drew near, Pizza Hut management decided it was time to press again for the full involvement of all franchisees in systemwide entry into the delivery market. Pizza Hut operated delivery units in 16 markets, with a total of 284 company-owned units. The company had hired and trained over 10,000 people. The flagship Norfolk market, which had experienced difficulties, was now profitable. The first half-year results from the operating units were impressive, and Delivery General Manager Huston was confident that the company could make a good business case for delivery.

Huston and the delivery group gave an extremely upbeat presentation of the delivery data to franchisees at the August meeting. Their purposes included (1) to convince franchisees that the time had come to give total support to the delivery effort, (2) to "sell" the company's delivery concept to the franchisees, and (3) to successfully launch the amendment negotiation process that was to begin in earnest after the meeting. While many franchisees remained adamantly opposed to delivery, others were becoming convinced that they could, in fact, increase their overall income with delivery even if they would face decreased average margins. While the idea of delivery became more acceptable, however, there was still little support for the particulars of the company's delivery concept.

The Current Situation

As the negotiations for an amendment to the Franchise Agreement continued into the fall of 1986, competition in the delivery market intensified tremendously. Systemwide, Domino's increased advertising 100% over the previous year. Moreover, much of its advertising was specifically focused on the markets Pizza Hut was attempting to open for delivery. Domino's spent an average of 68% more on advertising in those markets than in its other markets. Moreover, Domino's had proven to be an able competitor with satisfied customers and an inexperienced but highly enthusiastic franchise system. It met Pizza Hut head-on in each market Pizza Hut entered by focusing on execution, quality, advertising, and price.

Discounting became even more prevalent in late 1986. Fifty percent of Domino's pizzas were sold on deal. Pantera's joined Little Caesar in offering two-for-one deals; Godfather's and Pizza Inn launched their own delivery services also with deep price discounts. Delivery proved to be much more price, coupon, and deal sensitive than the traditional restaurant business.

Of the 19 Pizza Hut company-controlled markets open in December 1986, three were profitable. At the unit level, of the 361 company-owned operating delivery units, 194 were profitable. Company-owned delivery units that had opened early that year performed well from both a sales and profit perspective. The fierce competitive environment in markets opened later that year, however, led to slower sales growth and greater operating losses than expected for those units. For example, in one market, per-store average weekly sales rose to $6,600 after three weeks. Domino's had responded with two-for-one deals for three months, and the per-store average weekly sales dropped to around $4,850. Moreover, in markets with greater than $8,000 per-store average weekly sales in traditional restaurants, Pizza Hut delivery units averaged $7,300; in markets where traditional per-store average was less than $8,000, delivery units averaged only $4,225. Overall, the average weekly sales per delivery unit in December was $6,000.

Huston believed that some of the markets were overbuilt with delivery units and that Pizza Hut was getting all the sales that could be expected from those units. The ratio of traditional restaurants to potential customers averaged 1 restaurant to 70,000 people, while the delivery units averaged 1 unit to 40,000 people.

Consumer research had shown that the standard Pizza Hut pizza served in the traditional restaurants was not as well-suited to the delivery environment, causing quality to suffer. Pizza Hut research and development managers were confident that they could solve that problem by developing a new product designed especially for delivery. This would involve an entirely different production process than that used currently in the traditional restaurants.

Meanwhile, the number of franchisees who had introduced delivery was growing rapidly. Franchisees who in August had told Aaron that delivery would be "over their dead bodies" were inviting him to visit their delivery operations. Moreover, many franchisees who had introduced delivery were doing significantly better than the company-owned stores. Eighteen franchisees opened a total of 65 delivery-only units in 1986, bringing the overall total to 96. All but two units with over seven months' experience were profitable. In addition, by December 1986, 292 traditional restaurants had been retrofitted by franchisees to provide delivery service. Because the delivery operations were co-mingled with the eat-in and carryout operation in the retrofitted restaurants, it was difficult to estimate their profitability; however, the franchisees were reported to be pleased with the results so far. The franchisees' success with delivery was attributed to the fact that they had developed markets where they were already strong and had carefully picked the trade areas with the highest potential. They had also priced more competitively, and only 20% had upsized. Most kept costs low by having phone orders go direct to each separate unit instead of using Customer Service Centers.

The winter franchisee meeting was scheduled for January, and Reinemund, Huston, and Baxter had less than a month to decide how to proceed. Before deciding what to do at that meeting, they wanted to review the overall strategy and likely profit impact on Pizza Hut of delivery

Exhibit 1 Top Pizza Chains, 1986

	Systemwide Sales ($ millions)	Units	Average Check/Person	Delivery
Pizza Hut	1,934	5,025	$9.99	Separate delivery units plus franchisee add-on delivery out of restaurant
Domino's	1,550	3,696	$9.50	Delivery only
Little Caesar	520	1,308	$2.75	No delivery
Pizza Inn	278.7	748	$4.30	Separate delivery units
Godfather's	275	650	$9.75	Add-on delivery out of restaurant
Round Table Pizza	250	535	$5.00	Add-on delivery out of restaurant
Showbiz/Chuck E. Cheese	249	268	$5.20	No delivery
Shakey's	197	386	$4.25	Add-on delivery out of restaurant
Mr. Gatti's	139.2	319	$7.81	Add-on delivery out of restaurant

Adapted from *Nation's Restaurant News*

Exhibit 2 Pizza Hut Historical Data (U.S. domestic only)

	1979	1980	1981	1982	1983	1984	1985	1986
- *System net sales ($MM)*	732	832	1,007	1,170	1,394	1,566	1,743	1,934
- *Market share*[a]	14.9	15.7	17.0	17.2	18.0	17.3	16.0	15.4
- *Units*[b]								
- Company	1,940	1,888	1,843	1,845	1,911	2,051	2,224	2,534
- Franchise	1,801	1,873	1,922	1,975	2,095	2,157	2,309	2,491
- **Total**	3,741	3,761	3,765	3,820	4,006	4,208	4,533	5,025
- ***Company***								
- *PSA*[c] *sales ($M)*	196	221	267	306	348	372		
- (Traditional)							395	400
- (Delivery)							282	289
- *PSA sales growth*								
- Real	(3.1)	4.7	11.8	8.0	9.8	1.8	2.0	(2.0)
- Price	6.4	8.1	9.0	6.6	3.9	5.1	3.4	.8
- **Total**	3.3	12.8	20.8	14.6	13.7	6.9	5.4	(1.2)
- *Net sales ($MM)*	354	399	476	556	678	766	835	929
- Net sales growth (%)	–	12.7	19.3	16.8	21.9	13.0	9.0	11.3
- *Total revenues ($MM)*	495	556	489	569	699	795	867	967
- *ROAE (%)*[d]	3.5	6.1	8.9	16.4	21.7	16.9	15.0	12.4
- ***Franchisees***								
- PSA sales ($M)		237	280	314	350	386	400	415
- Net sales ($MM)	378	433	531	613	715	799	908	1,005

[a]Based on data from GDR/Crest Enterprises, Inc.

[b]Total number of U.S. domestic units of all kinds: restaurant, delivery, and mobile open that year

[c]PSA—Per Store Average: annual average computed by dividing total sales for each four-week store period by number of stores open during that period and then aggregating across all 13 store periods

[d]Return on Assets Employed: calculated as earnings divided by year's average net asset base

Exhibit 3A Traditional Red-Roof Pizza Hut Restaurant

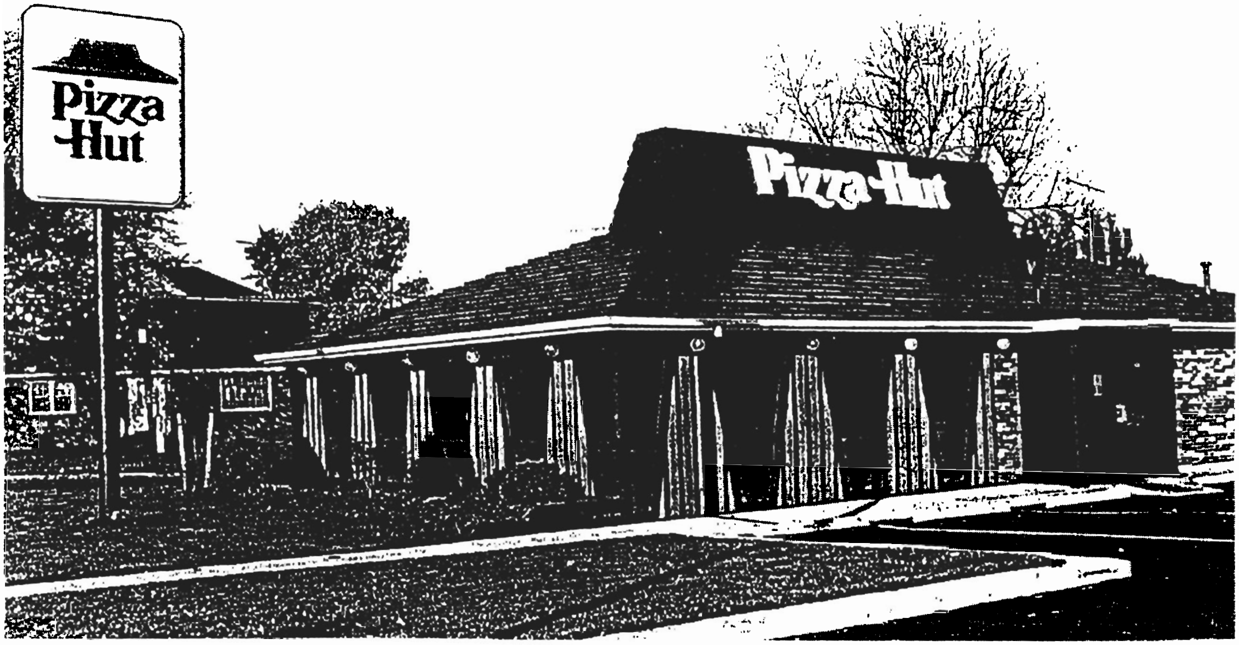

Exhibit 3B Delivery Unit

Exhibit 4 Pro Forma Profit and Loss Statement (based on $8,000/week sales)[a]

	Company-owned Traditional Restaurant	**Company-owned Delivery Unit**
Gross sales	100.0%	100.0%
Advertising, discounts, promotions, and allowances	16.5%	18.5%
Cost of sales[b] & labor	48.5%	46.2%
Semivariables & premiums[c]	8.7%	5.2%
Vehicles[d]	–	6.1%
Occupancy costs	6.0%	2.1%
General and administrative	7.2%	7.2%
Customer service center costs	–	5.9%
Net field contribution	13.1%	8.8%

[a]Percentages reflect an assumed $8,000/week store. As weekly sales decreased below $8,000, expenses as percent of sales increased significantly. At approximately $7,000/week, Delivery Unit net field contribution was 0.

[b]Cost of sales tended to be lower in the Delivery Units due to a combination of upsizing and higher prices per order. Labor costs for Delivery Units did not include order-taking expenses that were reflected in the Customer Service Center costs.

[c]Semivariables refers to utilities, uniforms, and other operating supplies. Premiums refers to items such as special glassware or toys that were given away or sold below cost to promote the sale of a particular menu item.

[d]Vehicle expenses reflect a mix of driver- and company-owned vehicles. Eighty percent of the delivery vehicles were owned by the drivers, who were reimbursed for their use per trip.

Exhibit 5 Organization Chart

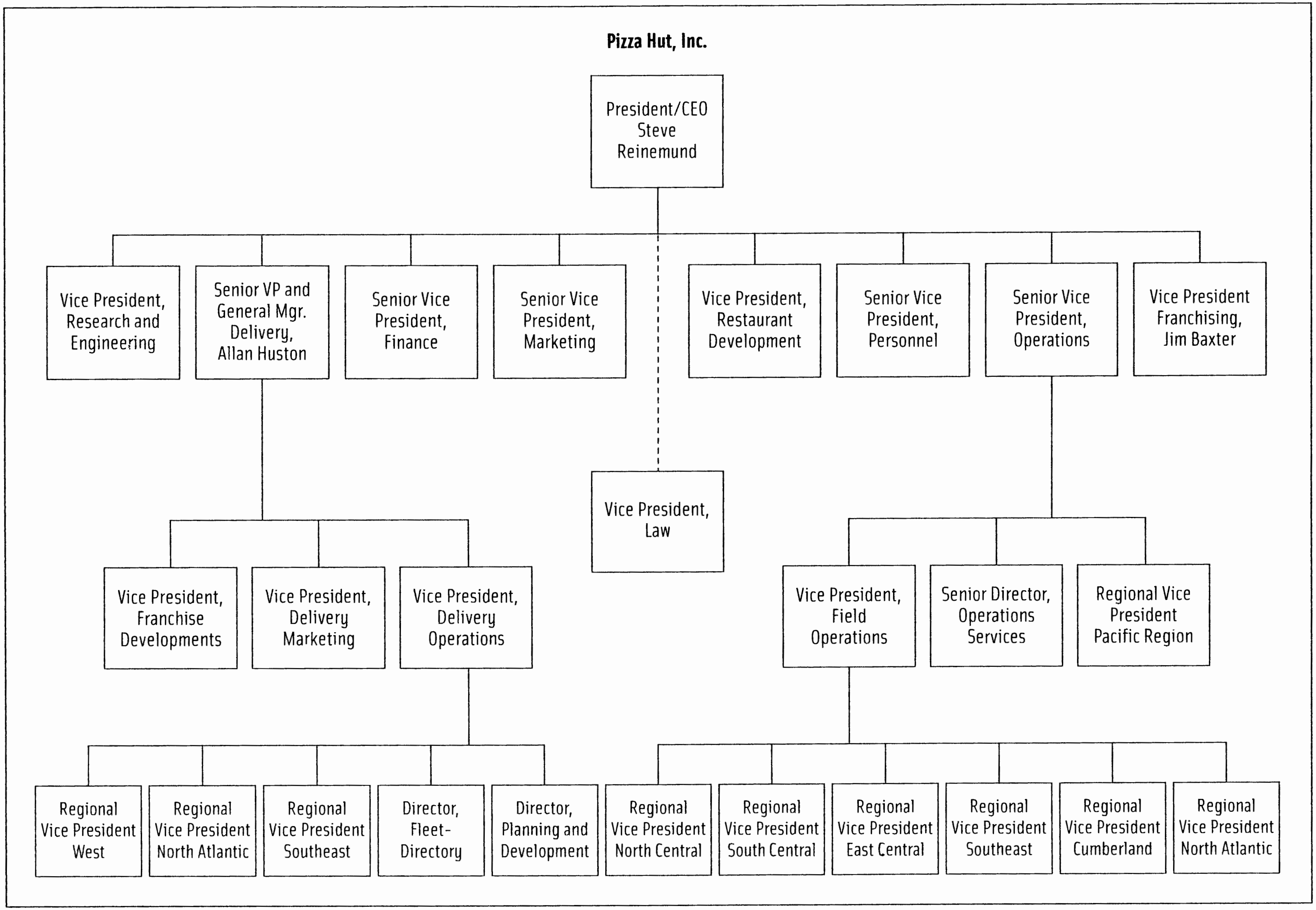

Exhibit 6 Open Pizza Hut System Traditional Restaurants and Delivery Units[a]

	Company-owned		Franchisee-owned		
	Traditional Restaurants	Delivery-only Units	Traditional Restaurants[b]	Retrofit	Delivery-only Units
August 1984	2,011	11	2,089	70	15
December 1984	2,025	16	2,137	98	20
August 1985	2,046	51	2,256	131	30
December 1985	2,004	78	2,352	162	46
August 1986	2,208	284	2,277	241	66
December 1986	2,173	361	2,395	292	96

[a]Domestic U.S. restaurants and delivery units only

[b]Totals for franchisee-owned traditional restaurants include those restaurants retrofitted to provide delivery service.