KFC: Doing Chicken Right in the U.S. Fast-Food Industry

I think our most critical issue in the future will be our ability to handle change. We have a concept that, in the last two years, has moved us out of the 1960s to perhaps the late 1980s. Unfortunately, it's 1994, and we have a lot more changes that need to take place in our system. Our system is older in terms of facilities and product forms, and our attitudes still don't reflect the realities of our changing business environment.

One of the great challenges at KFC is that there is a lot that needs fixing. It's like being a kid in a candy store—you don't know where to go first. I think one of the toughest challenges we have had is to stay focused. That is true on the menu side as well. People really see us as being the experts on chicken-on-the-bone. There is so much we can still do with products such as Rotisserie Chicken and different forms like that.

We also have a significant service problem in a service-driven industry. I think we have got to figure out a way to meet our customer service expectations, which we don't meet today. They come to us really because they love our product in spite of our service. And you can't survive long-term on that trail.

Kyle Craig, President,
KFC Brand Development, April 1994

In 1994, KFC remained the world's largest chicken restaurant chain and the world's third largest fast-food chain. It held almost 50 percent of the U.S. market in terms of sales and ended 1993 with over 9,000 restaurants worldwide. It was opening a new restaurant at a rate of roughly one per day worldwide and was operating in 63 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.

Craig found himself faced with a number of critical issues in 1994. Despite KFC's past successes in the U.S. market, much of KFC's growth was now being driven by its international operations, which accounted for over 87 percent of all new KFC restaurants built in 1993. Additionally, intensified competition among the largest fast-food competitors had resulted in a number of obstacles to further expansion in the U.S. market. Further expansion of free-standing restaurants was particularly difficult. Fewer sites were available for new construction and those sites, because of their increased cost, were driving profit margins down. Profit margins were driven down further by the need to promote the brand more rigorously, consumer pressure to reduce prices, the high cost of bringing new products to market, and higher operating costs.

Through the late 1980s, most of KFC's competition was limited to other fried chicken chains such as Church's, Popeyes, and Bojangles. Today, KFC is faced with competition from non-fried chicken chains such as Hardee's and McDonald's, who have introduced fried chicken to their menus. With KFC's menu limited to chicken, it has lost business to chains which offer customers a greater variety of food items that cut across different food segments. In addition, a number of new, upscale chicken chains—for example, Kenny Roger's Roasters and Boston Chicken—have entered the market. These new chains have focused on higher income customers by offering non-fried chicken items. Because KFC is best known for its fried chicken products, these new entrants are reaching out to customer groups which KFC is only now beginning

This case was prepared by Professor Jeffrey A. Krug of the University of Illinois, and Professor W. Harvey Hegarty of Indiana University. It is printed here with their permission.

to tap. Even Pizza Hut, a sister company of PepsiCo, has debated whether it should introduce chicken products to its menu.

KFC's early entry into the fast-food industry in 1954 allowed KFC to develop strong brand name recognition and a strong foothold in the industry. However, its early entry into the industry has also been the cause of many present day problems. By the mid-1980s, many of KFC's restaurants had begun to age and were designed mainly for take-out. As a result, KFC had to expend significant financial resources to refurbish older restaurants and add additional inside seating and drive-thrus, in order to accommodate customers' increasing demands for faster service.

KFC's major problem in 1994 was how to transition the old KFC into a new KFC which appealed to consumer demands for more healthy food items at lower prices, greater variety in food selection, and a higher level of service and cleanliness in a greater variety of locations. In effect, this entailed greater reflection over its entire business strategy—its menu offerings, pricing, advertising and promotion, points of distribution, restaurant growth, and franchise relationships.

THE U.S. FOOD SERVICE INDUSTRY

The concept of franchising became well-established by the early 1950s. Colonel Harland Sanders founded Kentucky Fried Chicken in 1954, Ray Kroc opened the first McDonald's restaurant in 1955, and Burger King quickly followed by opening its first restaurant in Miami, Florida. Other franchises founded in the 1950s were Chicken Delight, Burger Chef, Burger Queen, Carol's, and Sandy's. Today, the U.S. restaurant industry is made up of over 550,000 restaurants and food outlets, according to the National Restaurant Association (NRA). The NRA estimates that U.S. food service industry sales will surpass $275 billion in 1994. **Exhibit 1** shows U.S. food service industry sales segmented into 11 categories. For the first time, the fast-food segment is expected to become the largest segment of the U.S. food service industry, with forecasted sales of $86.0 billion in 1994. This compares with an estimated $85.5 billion in sales in the full service segment.

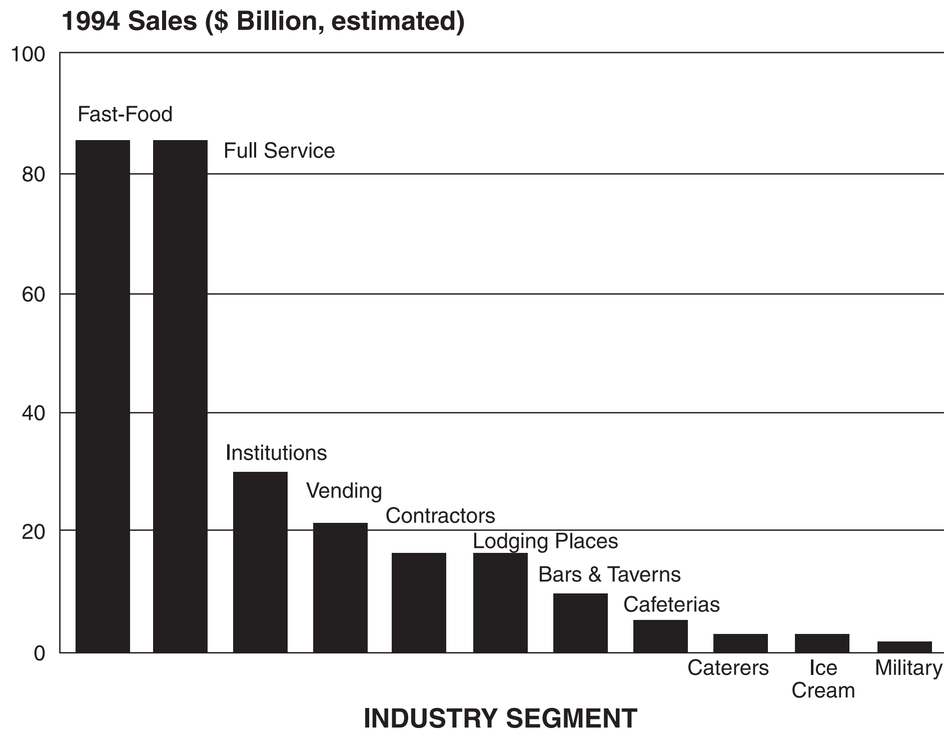
The U.S. food service industry as a whole grew at an estimated compounded annual growth rate of 3.9 percent from 1988 to 1994, compared with an annual growth rate of 5.4 percent in the U.S. gross domestic product. The fast-food segment of the food industry grew at a more healthy estimated rate of 5.6 percent, outpacing all food categories except social caterers and ice cream stores which grew only slightly more quickly. The NRA estimates that the fast-food segment will grow by 6.3 percent in 1994, following a 7.0 percent growth rate in 1993. While 11 categories of restaurants make up the food industry, the top three—fast-food, full service, and institutions—have maintained a constant share of about 73 percent of total industry sales. However, the share of industry sales controlled by the fast-food segment has risen by about 1.8 points over the last five years, mainly at the expense of full service restaurants and lodging places.

THE U.S. FAST-FOOD INDUSTRY

Financial and other data for the fast-food segment of the U.S. food service industry are most frequently reported for eight separate categories: sandwich chains, pizza chains, family restaurants, dinner houses, chicken chains, steak restaurants, contractors, and hotels. **Exhibit 2** shows sales for the largest 100 U.S. fast-food chains over the last five years. The top 100 chains have grown at a compounded annual rate of 6.4 percent over the last five years. Only three of the nine food categories have grown at greater than a 6.0 percent annual rate: pizza chains (7.8 percent), family restaurants (6.1 percent) and dinner houses (11.1 percent). The chicken segment has grown at a 4.1 percent compounded annual rate, partially reflecting the health trend away from fried foods and the addition of fried chicken and chicken sandwiches to the menus of sandwich chains, such as McDonald's and Hardee's. The latter have taken sales away from the chicken chains.

EXHIBIT 1
U.S. Food Service Industry Sales

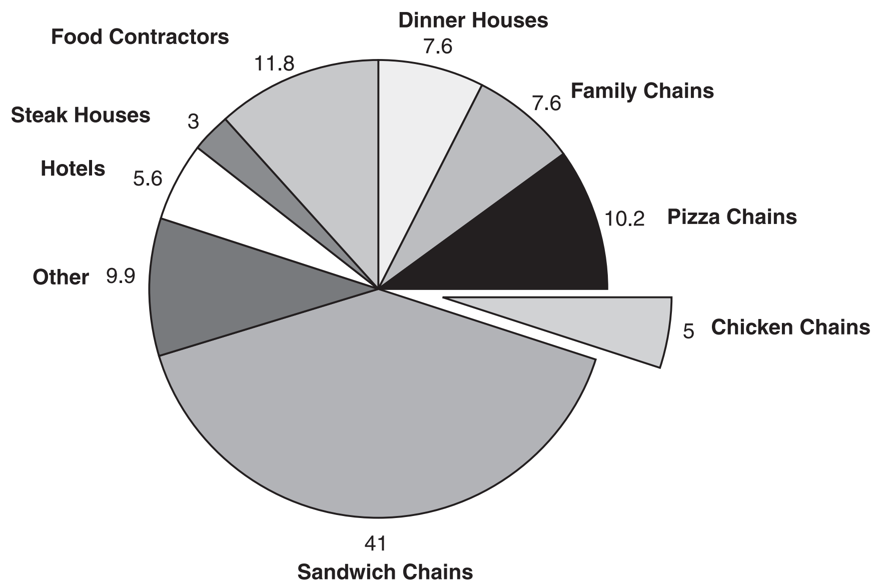
($ Billions)	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*5-Year Growth Rate*
Fast-Food	65.5	69.8	73.6	75.6	80.9	86.0	5.6%
Full Service	73.2	75.9	79.2	80.3	83.1	85.5	3.1%
Institutions	25.0	26.4	27.5	28.3	29.1	29.9	3.7%
Vending	18.0	16.3	19.9	20.3	20.7	21.6	3.8%
Food Contractors	13.1	14.1	15.0	15.5	15.8	16.4	4.7%
Lodging Places	14.1	14.9	14.3	15.2	15.1	15.5	1.9%
Bars & Taverns	9.0	8.7	8.6	9.2	8.9	8.8	–0.4%
Cafeterias	4.2	4.4	4.6	4.5	4.5	4.7	2.5%
Social Caterers	2.1	2.3	2.4	2.5	2.6	2.8	6.0%
Ice Cream	2.0	2.0	2.1	2.4	2.6	2.7	6.2%
Military	1.1	1.0	1.1	1.2	1.2	1.1	1.1%
Total Sales	227.2	235.8	248.0	254.9	264.6	275.1	3.9%



Source: Nation's Restaurant News, National Restaurant Association. 1994 sales estimated.

EXHIBIT 2
Top 100 Fast-Food Chain Sales by Food Segment ($ Billions)

($ Billions)	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*5-Year Growth Rate*
Sandwich Chains	30.9	33.2	35.6	36.7	39.7	41.0	5.8%
Pizza Chains	7.0	7.7	9.2	9.6	10.4	10.2	7.8%
Family Chains	5.7	6.6	6.4	7.0	7.7	7.6	6.1%
Dinner Houses	4.5	5.0	5.4	6.3	6.9	7.6	11.1%
Chicken Chains	4.1	4.2	4.6	4.5	4.7	5.0	4.1%
Steak Chains	3.4	3.5	3.4	3.5	3.3	3.0	–2.3%
Food Contractors	9.3	10.5	11.2	10.8	11.2	11.8	4.9%
Hotels	4.5	4.7	5.3	5.4	5.5	5.6	4.5%
Other	5.2	5.5	6.7	6.7	6.7	9.9	3.7%
Total Sales	74.6	80.9	87.8	90.3	96.1	101.8	6.4%



Source: Nation's Restaurant News.

Exhibit 2 indicates that the top four fastest growing categories within the fast-food industry control 65 percent of all fast-food sales. During the last six years, the market share held by these four categories has increased from 64.4 percent to 65.2 percent. All other categories, including the chicken category, have lost market share during this period. The most significant improvement in sales has occurred in the dinner house segment. Seven of the dinner house segment's 15 major restaurant chains registered double-digit sales growth in 1993: Outback Steakhouse (80 percent), Applebee's Neighborhood Grill & Bar (42 percent), Ruby Tuesday (25 percent), Red Robin Burger & Spirits Emporium (20 percent), the Olive Garden (18 percent), and Chili's Grill & Bar (15 percent).

Much of the improvement in sales among the dinner houses and family restaurant chains during the last decade is partially attributable to demographic trends in the United States. In particular, young people as a percentage of the population are declining. nose in the 18–24 year age group, for example, are of particular importance to fast-food restaurants because they consume about five meals away from home weekly, compared to under four meals for all consumers. While this age group nearly doubled during the 1960–1980 period, it will drop by about 20 percent by the year 2000. Those over the age of 65 tend to eat out less often, about two times per week, and this group is the most rapidly growing age group in the country. Older individuals tend to spend more time eating their meal, prefer sit-down restaurants, and are more likely to choose more upscale restaurants such as dinner houses. The higher price of the average meal in a dinner house is offset by the fewer times that older individuals eat out each week.

The initial high growth rates in fast-food franchising in the United States during the late 1950s and 1960s made the fast-food industry attractive to new entrants. The lack of established market share leaders and brand loyalties meant that there were relatively few companies that could defend against new market entrants. During this period, a number of fast-food chains were acquired by larger, diversified firms. Some of the most notable acquisitions were Pillsbury's acquisition of Burger King, General Foods' acquisition of Burger Chef (which was later sold to Hardee's Food Systems in 1982), Ralston-Purina's acquisition of Jack in the Box, United Brand's acquisition of Baskin-Robbins (which it later sold in 1973), and Great Western's acquisition of Shakey's Pizza.

The acquisition of a number of fast-food franchises by larger, more established marketing firms intensified competition during the 1970s. Not only were many fast-food chains owned by larger companies with resources enabling them to promote and invest heavily in their respective chains, but consumers increasingly demanded more value for their dollar. This further intensified competition and a second wave of acquisitions followed during this period. PepsiCo acquired Pizza Hut in 1977 and Taco Bell in 1978. KFC, which was sold by Heublein to R.J. Reynolds Industries in 1982, was also acquired by PepsiCo, in 1986. Other notable acquisitions during this period were Hardee's acquisition of Roy Rogers, Popeyes' acquisition of Church's, Tennessee Restaurant Company's acquisition of Friendly's Ice Cream, and Gibbons, Green von Amerongen's acquisition of Jack in the Box. Many of these acquisitions were made in order to strengthen the parent company's position within the fast-food industry (e.g. PepsiCo's decision to diversify into fast-food by acquiring Pizza Hut, Taco Bell, and Kentucky Fried Chicken). However, another factor that led to many of these acquisitions was the deteriorating financial position of smaller competitors, brought about by a lack of resources to compete with the market share leaders. A number of chains, therefore, became attractive takeover targets.

An interesting characteristic of the fast-food industry is that, in almost all cases, the leader in each food segment controls a large relative market share when compared to the market shares of its nearest competitors. **Exhibit 3** shows the market share leaders in the top six fast-food categories for the industry's leading chains. Only the steak restaurant segment has no clear market share leader. McDonald's controls 35 percent of the sandwich

EXHIBIT 3
Leading U.S. Fast-Food Chains (Ranked by 1993 Sales, $ 000s)

Sandwich Chains	*Sales*	*Share*	*Family Restaurants*	*Sales*	*Share*
McDonald's	14,186	34.6%	Denny's	1,634	21.4%
Burger King	6,720	16.4%	Shoney's	1,318	17.3%
Taco Bell	3,608	8.8%	Big Boy	1,064	14.0%
Wendy's	3,547	8.7%	Cracker Barrel	640	8.4%
Hardee's	3,505	8.5%	Perkins	578	7.6%
Subway	2,133	5.2%	Friendly's	611	8.0%
Arby's	1,596	3.9%	Int'l House of Pancakes	552	7.2%
Dairy Queen	1,085	2.6%	Bob Evans	480	6.3%
Jack in the Box	1,018	2.5%	Bakers Square	280	3.7%
Sonic Drive-In	650	1.6%	Waffle House	275	3.6%
Roy Rogers	635	1.5%	Other Restaurants	217	2.8%
Other Chains	2,312	5.6%	Total	7,649	100.0%
Total	40,995	100.0%			

Dinner Houses	*Sales*	*Share*	*Pizza Chains*	*Sales*	*Share*
Red Lobster	1,732	22.7%	Pizza Hut	4,800	47.9%
Olive Garden	1,055	13.8%	Little Caesers	2,150	21.4%
Chili's Bar & Grill	788	10.3%	Domino's Pizza	1,877	18.7%
T.G.I. Friday's	671	8.8%	Round Table Pizza	347	3.5%
Applebee's	605	7.9%	Sbarros	346	3.5%
Bennigan's	446	5.9%	Chuck E. Cheese's	294	2.9%
Chi-Chi's	406	5.3%	Other	407	2.1%
Ruby Tuesday	354	4.6%	Total	10,221	100.0%
Outback Steakhouse	348	4.6%			
Ground Round	302	4.0%			
Other Dinner Houses	916	12.0%			
Total	7,623	100.0%			

Steak Houses	*Sales*	*Share*	*Chicken Chains*	*Sales*	*Share*
Ponderosa	762	25.2%	KFC	3,400	67.7%
Sizzler	672	22.2%	Popeyes Chicken	564	11.2%
Golden Corral	515	17.0%	Church's Chicken	439	8.8%
Ryan's	450	14.9%	Chick-fil-A	396	7.9%
Western Sizzlin'	350	11.6%	Boston Chicken	152	3.0%
Quincy's	279	9.2%	Kenny Rogers Roasters	69	1.4%
Total	3,028	100.0%	Total	5,020	100.0%

Source: Nation's Restaurant News, National Restaurant Association.

segment. Red Lobster controls 23 percent of the dinner house segment. Pizza Hut and KFC, both subsidiaries of PepsiCo, Inc., control 48 percent and 68 percent of their respective food segments.

Demographically, consumers became more and more demanding during the 1980s. In 1991, the National Restaurant Association conducted a survey to measure consumer attitudes toward fast-food and moderately-priced restaurants. Of those consumers who said they would rather go to a fast-food restaurant than any other type of restaurant under most circumstances, 48 percent mentioned being in a hurry, being busy, and wanting fast service as the major factor in their choice of a fast-food restaurant. Convenience, expense, "didn't feel like cooking," and quality were less important. This trend was further supported in a 1992 survey by the National Restaurant Association, which found that 66 percent of the respondents felt that their expectations of the value they received at fast-food restaurants for the price paid was generally met. Twenty-three percent of the respondents felt that the value they received for the price paid fell below their expectations.

By 1994, however, consumers had become more demanding. In addition to demanding faster service, consumers were increasingly demanding a greater variety of menu items, greater value for their dollar, and fast-food available at a greater number of non-traditional outlets, such as airports. This resulted in a number of fast-food chains (such as McDonald's, Taco Bell, and Wendy's) offering combinations of food items ("value meals") at lower prices and several fast-food chains cutting across food segments by offering products not traditionally offered by other competitors in their food segment (for example, Hardee's offering fried chicken). The latter has affected KFC, which competes exclusively within the chicken segment.

THE CHICKEN SEGMENT OF THE FAST-FOOD INDUSTRY

Worldwide sales of U.S. chicken chains surpassed $9.0 billion in 1993. KFC held a worldwide market share of over 70 percent in both sales and restaurants. By the end of 1993, KFC had 9,033 restaurants in 63 countries. Only about one-half of all chicken chains had established restaurants outside of the United States by mid-1994. In contrast, KFC opened its first restaurant outside of the U.S. in the late 1950s. KFC's early expansion abroad, its strong brandname, and managerial experience operating in international markets partially explains KFC's dominant market share.

KFC also leads all chicken chains in sales and units in the U.S. market; however, it faces much stronger competition domestically. (See **Exhibit 4**.) During the last five years, KFC's sales have grown at a 3.2 percent annual rate, even though it has outpaced the overall chicken segment, which has grown at an average annual rate of 2.5 percent. Only Chick-fil-A has gown at a rate faster than GDP. While KFC, Popeyes, and Church's have focused on unique fried chicken recipes served to customers in free-standing restaurants, Chick-fil-A serves pressure-cooked and char-grilled skinless chicken breast sandwiches to customers in sit-down restaurants located in shopping malls. One of the first fast-food restaurants to break into shopping malls, Chick-fil-A opened its first restaurant in the Greenbrier Mall in Atlanta in 1967.

Chick-fil-A

Chick-fil-A's relatively high growth rate during the last five years may at first appear surprising, considering the culture at Chick-fil-A and the management style of S. Truett Cathy, Chick-fil-A's founder, chairman, and chief executive officer. Cathy, a strongly religious man, keeps all Chick-fil-A stores closed on Sundays. He also refuses to take the company public, will not franchise, and does not aggressively advertise his product or concept. Cathy is also involved in a variety of community activities which take him away from the day-to-day operations of his business, and he contributes heavily to youth programs, charities, and scholarship funds.

EXHIBIT 4
Top U.S. Chicken Chains

Sales ($ Millions)	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*5-Year CAGR*
KFC	2,900	3,000	3,249	3,200	3,400	3,400	3.2%
Popeyes	485	510	560	536	545	564	3.1%
Church's	406	466	445	415	414	439	1.6%
Chick-Fil-A	232	264	300	325	356	396	11.3%
Top U.S. Chains	4,023	4,240	4,554	4,476	4,715	4,779	3.6%
Other Chicken Chains	2,177	1,760	1,846	2,325	2,286	2,201	0.2%
Total U.S. Market	6,200	6,000	6,400	6,801	7,001	7,000	2.5%

Year-End Restaurants	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*5-Year CAGR*
KFC	4,923	4,937	5,006	5,056	5,089	5,128	0.8%
Popeyes	715	739	778	794	775	764	1.3%
Church's	1,363	1,111	1,059	1,021	944	932	–7.3%
Chick-Fil-A	406	411	441	465	487	545	6.1%
Top U.S. Chicken Chains	7,407	7,198	7,284	7,336	7,295	7,369	-0.1%
Other Chicken Chains	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Total U.S. Market	7,407	7,198	7,284	7,336	7,295	7,369	–0.1%

Source: Nation's Restaurant News.

Chick-fil-A's corporate culture and new distribution strategy, however, have helped Chick-fil-A maintain high growth rates in sales over the last five years despite slow overall growth in the chicken segment. For example, Cathy is well-known for treating his employees like family members. This has resulted in low turnover rates among both managers and part-time workers. In addition, Cathy has taken the step to expand beyond shopping malls. As many malls have added food courts, often consisting of up to 15 fast-food units competing side-by-side, shopping malls have become less enthusiastic about allocating separate store space to food chains. In addition to Chick-fil-A's original sit-down mall stores, it has begun opening smaller units in shopping mall food courts, free-standing units, restaurants in hospitals and colleges, and "Dwarf Houses" (full service restaurants which offer hamburgers and steaks as well as chicken).

Church's and Popeyes

Much of the slow growth in sales and units in Popeyes and Church's is a function of financial problems during the last five years. In 1989, the San Antonio-based Church's Fried Chicken was acquired in a hostile takeover by Al Copeland, owner of Popeyes Famous Fried Chicken & Biscuits. The $400 million leveraged buy-out of Church's was financed through Merrill Lynch and the Canadian Imperial Bank of Canada. Most of the financing was achieved through the issue of junk bonds. Merrill Lynch and CIBC's fee was $58 million!

Copeland's strategy was two-fold: (1) to convert Church's restaurants into Popeyes restaurants and (2) to sell off several hundred Church's restaurants in order to cover interest and debt payments arising from the acquisition of Church's. **Exhibit 4** shows that both sales and the number of Church's

restaurants began to fall in 1990. Sales began to rise again in 1993. Popeyes achieved a five-year growth rate in sales of 3.1 percent, equal to the growth rate of KFC during this period. The growth of Popeyes units grew at a lower 1.3 percent annual rate. Much of this growth, of course, was achieved through the conversion of Church's units into Popeyes units. In a 1992 court battle, Copeland was forced out as owner of Popeyes and Church's, and the two units became divisions of America's Favorite Chicken Co., a subsidiary of the Canadian Imperial Bank of Canada and Copeland's major financial backer during the 1989 takeover of Church's.

A major issue facing Church's and Popeyes in 1994 was whether they could survive over the long term. Not only were they far behind the market share leader, KFC, but they had been unable to make market share gains over the last 10 years. in addition, the organization was burdened by large debt that had accumulated as a result of Al Copeland's acquisition of Church's and subsequent financial problems, which ultimately led to Copeland's downfall. There was also some concern that Church's and Popeyes' current owner, the Canadian Imperial Bank of Canada, did not have the managerial knowhow or expertise to operate Church's and Popeyes other than as autonomous units. The Canadian Imperial Bank's eventual takeover of Church's and Popeyes was a court-approved remedy for Al Copeland's inability to repay the bank for the bark's financial support of Copeland's acquisition of Church's. Therefore, there was little strategic fit or opportunity to transfer value from the parent to the newly acquired chicken chains.

Boston Chicken

Through the early 1980s, all of the leading chicken chains focused on fried chicken products. However, by the mid-1980s, all of the fast-food chains had begun to recognize the need to introduce products which appealed to an increasing health-conscious consumer. To address these needs, the major chicken chains added healthier products to their menus such as grilled chicken sandwiches and rotisserie chicken. However, they continued to emphasize what they did best—fried chicken-on-the-bone.

In 1985, a new restaurant called Boston Chicken was opened in Newton, Massachusetts. Instead of offering a wide range of fried and non-fried chicken products, Boston Chicken chose to build a concept around a single product: marinated, slow-roasted chicken. Part of Boston Chicken's strategy was to differentiate itself from other fast-food restaurants by emphasizing the "home-cooked" nature of its products. The menu was simple. Customers would choose a quarter or half chicken, white or dark meat, and two side orders. Side orders were selected from a variety of food items in a delicatessen-like display case. Corn bread was included with every meal. In addition to its roasted chicken meals, the menu included chicken sandwiches, chicken soup, chicken salad, and chicken pot pie. All food items were made from scratch, further enhancing the restaurant's image for "home-cooked" rather than "fast" food. Units were simple and clean and the decor was designed to give the appearance of a delicatessen. While units were designed mainly for take-out, no drive-thrus were used. This further enhanced its delicatessen image. Prices were slightly higher than other chicken chains, but this fit with the "home-cooked" image of the restaurant and appealed to professionals and other higher income customers.

On November 9, 1993, Boston Chicken went public. From an initial offering of $20 per share, the price jumped to $48.50 by the close of the day, a 143 percent increase. According to NASDAQ, it was the largest first-day increase in stock price of any new stock in any industry in over two years. Total market capitalization was $18.6 million. Boston Chicken's first annual report, for the year ended December 26, 1993, showed the company's first profit; net income of $1.6 million on revenues of $42.5 million. This represented a 413 percent increase in revenue from the previous year.

KENTUCKY FRIED CHICKEN CORPORATION

Parent-Subsidiary Relationship

When PepsiCo, Inc. acquired KFC from RJR-Nabisco in 1986, KFC's relationship with its parent company underwent dramatic changes. RJR-Nabisco ran KFC as a semi-autonomous unit, satisfied that KFC management knew the fast-food business better than they. In contrast, PepsiCo acquired KFC in order to complement its already strong presence in fast-food. After its acquisition of KFC, PepsiCo had the leading market share in chicken (KFC), pizza (Pizza Hut), and Mexican food (Taco Bell). However, 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 throughout 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."

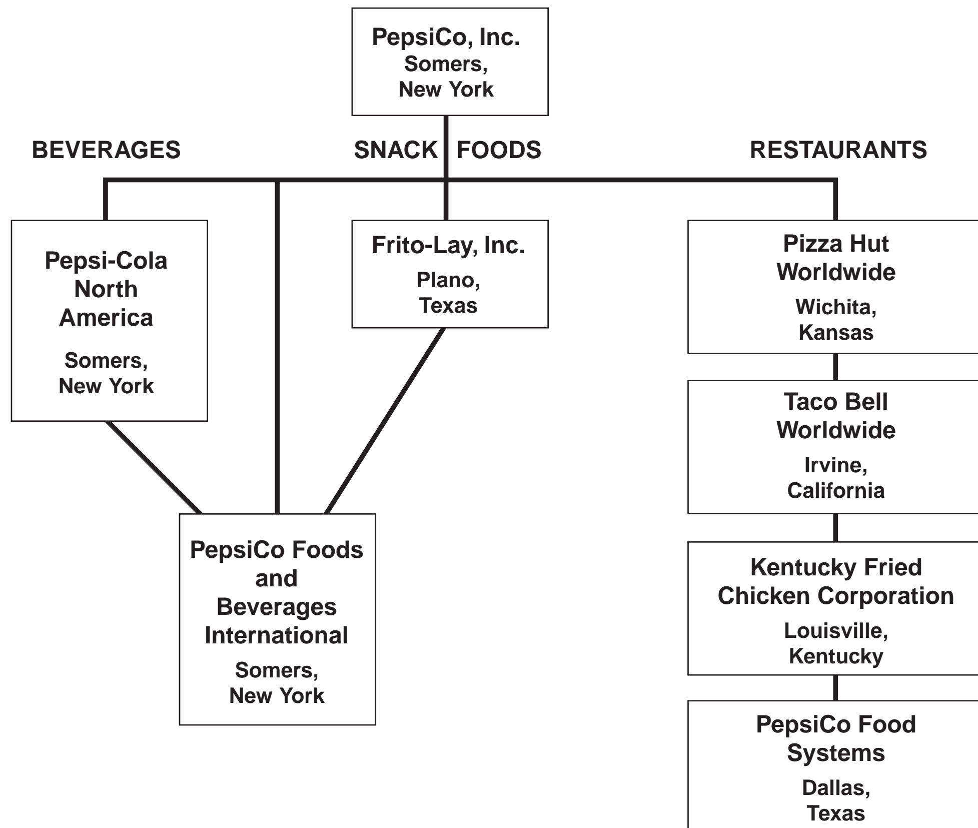
Such statements by PepsiCo personnel, uncertainties created by several restructurings which led to layoffs throughout the KFC organization, the replacement of KFC personnel with PepsiCo managers, and conflicts between KFC and PepsiCo's corporate cultures created a morale problem within KFC. "Colonel" Sanders' philosophy when he founded KFC was to create an organization with a relaxed atmosphere, life-time employment, good employee benefits, and a system of relatively independent franchisees. In stark contrast to KFC's culture, PepsiCo's culture was characterized by a strong emphasis on performance. PepsiCo used its Taco Bell, Pizza Hut, and KFC operations as training grounds for its future top managers and rotated its best managers, on average, every two years among its KFC, Taco Bell, Pizza Hut, Frito-Lay, and Pepsi-Cola subsidiaries. (See **Exhibit 5**.) Therefore, there was immense pressure for managers to continuously show their managerial prowess within short periods, in order to maximize their potential for promotion. However, KFC personnel were often chosen from outside the KFC organization or hired through executive consultants. This practice left many existing KFC managers with the feeling that they had few career opportunities with the new company. One KFC manager, who asked not to be identified, commented that a senior manager told him that "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."

Officially, PepsiCo managers were given autonomy to make their own decisions. In reality, PepsiCo kept a tight reign on its units. This was partially the result of its policy of continuously evaluating managers for promotion. Accounting, MIS, and financial planning systems were dictated from PepsiCo and much of KFC's capital expenditures were allocated by PepsiCo from other PepsiCo units. For example, in 1993, KFC accounted for 5.3 percent of PepsiCo's consolidated operating profit but 12.5 percent of total capital spending. In contrast, Frito Lay accounted for 40.9 percent of PepsiCo's overall 1993 operating profit but 24.5 percent of capital spending.

Asked about KFC's relationship with its parent, Kyle Craig 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.

EXHIBIT 5
PepsiCo, Inc. Organizational Chart



Source: PepsiCo, Inc. *Annual Report*, 1993.

Even now, though, that is still not universally understood. PepsiCo pushes their 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.

Financial Results

Exhibits 6 and **7** show KFC's corporate sales and profits since 1991. KFC corporate sales continue to grow sales at a healthy rate. Sales grew at a compounded annual growth rate of 13.6 percent during, the last five years. Sales were up 7.2 percent in 1993, mainly because of new restaurant construction outside the United States, higher pricing in U.S. restaurants, and higher franchise royalty revenues. Foreign restaurants continue to account for

EXHIBIT 6
PepsiCo, Inc. Corporate Net Sales ($000s)

		1991		1992		1993
Beverages		6,915.2		7,605.6		8,638.2
Snack Foods		5,250.1		6,132.1		7,026.8
Restaurants		7,126.9		8,232.3		9,355.7
Pizza Hut	3,258.3		3,603.5		4,128.7	
Taco Bell	2,038.1		2,460.0		2,901.3	
KFC	1,830.5		2,168.8		2,325.7	
Total		19,292.2		21,970.0		25,020.7
Domestic		15,167.8		16,551.0		18,309.1
International		4,124.4		5,419.0		6,711.6
Total		19,292.2		21,970.0		25,020.7

Source: PepsiCo, Inc. *Annual Reports*.

Note: Sales data include sales from company restaurants and royalties from franchises (sales from franchises are excluded).

roughly 30 percent of KFC's total revenues. Profits grew at a compounded annual rate of 9.2 percent, slightly lower than sales. This was primarily the result of higher labor, operating, and promotion costs in the U.S. Despite an increase in 1993 sales, 1993 profits were down 9.5 percent compared to 1992. Profits were affected mainly by lower international profits resulting from higher store level operating costs, higher international administrative and support expenses, and start-up costs associated with the roll-out of new roasted chicken products in the United States and Australia.

EXHIBIT 7
PepsiCo, Inc. Corporate Operating Profits ($000s)

		1991		1992		1993
Beverages		863.3		798.6		1,109.0
Snack Foods		756.7		984.7		1,189.6
Restaurants		575.5		718.5		778.0
Pizza Hut	314.5		335.4		372.1	
Taco Bell	180.6		214.3		253.1	
KFC	80.5		168.8		152.8	
Total		2,195.6		2,501.8		3,076.6
Unallocated Expenses		–83.8		–130.6		–170.1
Total		2,111.8		2,371.2		2,906.5

Source: PepsiCo, Inc. Annual Reports.

Note: Operating profits include profits from company-owned restaurants only.

Slower restaurant growth and lower profits in the U.S. reflect a variety of factors. First, new, upscale chicken chains such as Boston Chicken and Kenny Rogers Roasters, have attempted to cut out a market niche by marketing non-fried chicken products to higher income consumers. Second, many sandwich chains have introduced fried chicken and Chicken sandwiches to their menus. By widening their menus, sandwich chains have appealed to families who need to satisfy different family member preferences. Third, all competitors in the fast-food industry have been under pressure to lower prices while at the same time improving menu offerings and service. All of these factors have made it more difficult for individual KFC restaurants to increase sales from year to year.

Exhibit 8 shows KFC's worldwide restaurant growth during the last eight years. Increasingly, most of KFC's new restaurant construction is outside of the United States. Of 304 new restaurants built in 1993, only 39 were constructed in the U.S. While international restaurant construction has grown at a compounded annual rate of 11.2 percent, U.S. restaurant construction has grown at a low 1.2 percent annual rate.

Business Strategy

Before 1986, KFC's menu offerings were relatively limited. Its major product offerings were its Original Recipe and Extra Crispy fried chicken products. However, by the mid-1980s slowing per store sales and increased competition among fast-food competitors led KFC to aggressively develop new products to appeal to a wider variety of consumers. In 1987, Chicken Littles were introduced. Designed as a snack product, Chicken Littles consisted of a small chicken patty in a small bun. One year later, KFC introduced its full-size chicken filet burger. Both products, however, were only modestly successful and ultimately withdrawn from KFC's menu. In 1993, KFC introduced a full-size barbecue sandwich, which has been only modestly received.

KFC has introduced a variety of other products during the last four years in order to expand its consumer base to lunch and snacks. In 1990, Hot Wings and Spicy Chicken were introduced. In 1992, Honey BBQ chicken, Oriental Wings, and Pop Corn Chicken were introduced as limited time offerings to attract new customers. In October 1993, KFC

EXHIBIT 8
KFC Worldwide Restaurant Growth

Year	*U.S. Stores*	*New Builds*	*% Total*	*Int'l Stores*	*New Builds*	*% Total*	*Worldwide Stores*	*New Builds*	*%Total*
1986	4,720	—	71.8%	1,855	—	28.2%	6,575	—	100.0%
1987	4,814	94	64.0%	2,708	853	36.0%	7,522	947	100.0%
1988	4,899	85	63.1%	2,862	154	36.9%	7,761	239	100.0%
1989	4,961	62	62.4%	2,987	125	37.6%	7,948	187	100.0%
1990	5,006	45	61.1%	3,181	194	38.9%	8,187	239	100.0%
1991	5,056	50	59.6%	3,424	243	40.4%	8,480	293	100.0%
1992	5,089	33	58.3%	3,640	216	41.7%	8,729	249	100.0%
1993	5,128	39	56.8%	3,905	265	43.2%	9,033	304	100.0%

Source: PepsiCo. Inc. *Annual Reports*.

introduced its Rotisserie Gold chicken nationally. The introduction of Rotisserie chicken received a tremendous response. During the fourth quarter of 1993, KFC reported a 10 percent increase in sales in restaurants which offered the new roasted chicken product.

In response to competition from sandwich chains and the consumer trend toward increased value, KFC made the decision to test an all-you-can-eat buffet in one of its franchises in Arkansas in 1991. The buffet, which was offered for $3.99 (lunch) and $4.99 (dinner) (1994 prices), offered up to 30 food items including fried chicken, biscuits, a salad bar, and vegetable bar. The buffet was introduced into 675 units by the end of 1992. Ultimately, KFC plans to introduce the buffet into about one-half of its domestic restaurants.

KFC's image as a fried chicken chain and the older age of many of its restaurants led to a new campaign to upgrade its restaurants in the mid-1980s. By 1994, over three-fourths of all KFC restaurants in the U.S. had been refurbished. In addition, KFC outfitted many of its restaurants with additional seating and drive-thrus, in order to accommodate increased consumer demand for both indoor seating and faster take-out service. In 1986, about three-fourths of KFC's sales were take-out. Take-out sales had fallen to about one-third of all sales by 1988 and have continued to fall since that time. In order to help dispel KFC's image as a fried chicken chain, Kyle Craig made the decision in 1990 to change the restaurant chain's official logo from Kentucky Fried Chicken to KFC. While the old Kentucky Fried Chicken signs can still be seen in KFC's older restaurants, its newer restaurants have signs that carry only the initials "K F C" accompanied by the profile of Colonel Sanders, KFC's founder.

One of the most difficult problems for KFC in 1994 was distribution. Because KFC's domestic restaurant construction program has slowed during, the last five years, KFC has searched for new ways to grow the KFC brand domestically. When asked how KFC planned to grow its brand in the future, Kyle Craig commented:

> You know that McDonald's is still building a couple hundred restaurants a year, but we are not building a lot of traditional (free-standing) restaurants. But the business is changing. It is very expensive to build today, for us it is about a million dollars per restaurant. The returns are not what they once were so as opposed to going in and building traditional million dollar restaurants, we are saying, hey, does it make more sense to go into other types of distribution centers; does it make sense to set up a delivery unit that may be much less expensive a way to expand both our points of distribution and consumer access to our products? I think we will find much more financially viable ways to grow the brand and we are trying to do it both for ourselves and for our franchisees.

Franchising Problems

KFC's ability to expand its distribution base was limited by an on-going feud with its franchisees. Through the mid-1980s, KFC's franchisees had been allowed to operate with little interference from KFC management. This "hands-off" approach could be traced back to the 1950s when Harland Sanders sold his first franchise, and resulted mainly from the Colonel's lack of interest in franchise affairs. Over time, franchise independence became a deeply rooted part of KFC's corporate culture. As a result of their independence, and the control they had over their day-to-day operations, KFC franchisees developed a strong devotion to both the Colonel and the KFC organization.

When PepsiCo acquired KFC in 1986, one of its first steps was to renegotiate a new contract which would give it more control over franchises' menu offerings and operations, allowed it to close unprofitable franchises, and allowed it to take over franchises that were poorly managed. Such actions were viewed as critical to improving product and service consistency and improving KFC's QSCV (quality, service, cleanliness, value) image. In addition, KFC believed that future growth in the KFC concept would come from smaller KFC units in shopping malls, colleges, and hospitals. In many cases, this meant that KFC would have to build units within close proximity of existing KFC franchises.

The last contract between KFC and its KFC's franchisees, prior to KFC's acquisition by PepsiCo, was negotiated in 1976. This contract stipulated that KFC would not build any KFC unit within 1.5 miles of an existing franchise. This stipulation was designed to protect existing franchises from lost sales to new KFC units built within these 1.5 mile protection zones. The 1976 contract also gave franchises power over supplier sourcing and the right of automatic contract renewal. The new contract would eliminate the 1.5 mile protection zone, eliminate automatic contract renewal, and increase PepsiCo's control over supplier sourcing. In 1989, the Association for Kentucky Fried Chicken Franchises (AKFCF) sued KFC over its new contract. In December 1993, KFC guaranteed that they would adhere to the 1.5 mile limit for seven months and Kyle Craig personally pledged not to open new full-service restaurants, home delivery, or take-out units within 1.5 miles of an existing franchise. However, the law suit remained unresolved in a Kentucky federal court in late 1994.

CONCLUSION

KFC faced a variety of problems and issues in 1994. Still the world's largest chicken chain and third largest fast-food chain, it continued to grow at a healthy rate worldwide. It also continued to control one-half of all chicken chain sales in the U.S. and had one of the world's most recognized brands. In addition, its new rotisserie chicken and buffet had been tremendously successful in those markets where they had been introduced. However, while prospects for continued growth internationally were bright, continued growth within the domestic market was threatened by a number of industry and societal trends. Competition from sandwich chains and new chicken chains, as well as consumer demand for a wider variety of menu offerings, forced KFC to reanalyze its product strategy. At the same time, KFC and other fast-food competitors were forced to improve product offerings and to serve their product faster and with better service to consumers who increasingly demanded greater value for their money. Asked to comment on KFC's situation, Kyle Craig responded:

> We are in a fairly complex business with lots of agendas. Our franchises want one thing done, PepsiCo wants something else done, and our field operators want something done differently than the company. There has to be a central location where key decisions are made and a vision for the business is established. I think I, or another leader, has to be that visionary. Our number one issue is our ability to handle change. We have introduced the Rotisserie product and that's given our franchises some confidence, but this franchise situation has been very difficult. If we can resolve that in the next year or two we really could operate as a unified system as opposed to 3,000 franchise stores going one way and 2,000 company stores going another way. People do see us now as doing a better job of meeting their variety needs and recognize that we are not solely dependent on fried chicken, but they don't yet see us as contemporary, as we would like them to in the long-term. This is particularly true of people who do not presently patronize KFC. Today's consumer is less loyal, more value driven, and much more information based. The only thing that I am sure of is that tomorrow's consumer is going to be even more demanding.