Surpassing Stall Points in Scaling New Heights

BY KEE Koon Boon

2011 marks the 50th "anniversary" since Ray Kroc, 59 years old then, bought out McDonald's for US$2.7 million from the McDonald brothers who were the original pioneers of the fast food restaurant "system"– an expensive valuation then and with no secret recipe for hamburgers, no patents, and no technological breakthroughs. Since fully taking charge of McDonald's destiny, Kroc, the visionary leader, enlisted the help of a team with Fred Turner as the execution extraordinaire, June Martino as the human resource specialist, and Harry Sonnenborne as the numbers guy who advised him that real estate was the key to a franchise's financial success.

By 1965, the year when McDonald's was listed – interestingly, at the same time as Singapore's independence – the team had scaled the business nationwide with tenacity to more than 700 restaurants amidst the thicket of resource-rich incumbents, aggressive competitors under the wings of corporate giants, and copycats. McDonald's now has more than 32,000 restaurants worldwide in 117 countries and two-thirds of its sales are now contributed from outside of America. More than 75 percent of McDonald's restaurants worldwide are owned and operated by independent local men and women. McDonald's is also one of the largest property companies with US$17.6 billion in self-owned "McProperty" real estate retail assets. The company's market capitalization has since multiplied 140 times in 45 years to US$88 billion currently.

Why McDonald's, easily one of the most recognizable brand name in the world, is not a core buy-and-hold stock in the portfolio of Warren Buffett, the world's greatest value investor, is probably one of the greatest underexplored enigmas in value investing. The non-investment by Buffett's Berkshire Hathaway is all the more ironic given that McDonald's is the biggest buyer of Coke – and the Golden Arches was also listed in the same year as Berkshire. Having multiplied his returns by 10-folds after investing in Coca-Cola in a big way in 1988, the ubiquitous beverage brand is arguably the business model that most define Buffett's philosophy in value investing.

When asked whether he would buy McDonald's and go away for twenty years, Buffett gave an intriguing reply in a lecture at the Florida School of Business back in October 1998. "It is a tougher business over time", Buffett said, "People don't want to be eating – exception to the kids when they are giving away Beanie Babies or something – at McDonald's every day. If people drink five Cokes a day, they probably will drink five of them tomorrow… I like the products that stand alone absent price promotions or appeals although you can build a very good business based on that."

Buffett's Berkshire Hathaway did purchase McDonald's in 1995/6 when it was probably around US$17 to 20 billion, but he exited in 1997/8 at around US$26 to 30 billion. Although McDonald's grew to US$50 billion around a year later, it started its precipitous trend to fall to US$13 billion by February 2002 as it posts its first ever quarterly loss. Singapore's dynamic entrepreneur Robert Kwan, who had a small wholesale toy store, was earlier than Buffett, opening with sharp foresight the first McDonald's in Singapore in 1979 at Liat Towers, although he sold off his share in the business in 2003. Mr. Kwan carried his experience and insights to rejuvenate the Singapore Zoo, Bird Park and

Night Safari, bringing them back into the black in his role as the executive chairman of Wildlife Reserves Singapore in 2003, later stepping down in 2007.

"A tougher business over time", an all-important axiom for entrepreneurs and value investors.

Coca-Cola itself hit its peak at around US$200 billion in market cap in Jul 1998 before dwindling to US$90 billion by 2005 and recovering to US$165 billion presently. Starbucks, in its 40th "anniversary" this year, poured its heart to scale one cup at a time after Howard Schultz bought over the six Starbucks shops for US$4 million in 1987 to reach US$28 billion in 2006 before hitting the roadblock to tumble to US$7 billion by end 2008 and is now back up again to US$38 billion.

Most businesses are not so fortunate to be able to recover. In 1962, the year IBM turned 50, Tom Watson Jr. – IBM's chairman and the son of its founder – commented that of the top 25 industrial corporations in the United States in 1900, only two remained on that list by 1961. This year in 2011, as IBM celebrated its centennial, its current CEO Sam Palmisano carried on Watson's insight and said that of the top 25 companies on the Fortune 500 at the time of Watson's lecture, only four remained in 2010.

Is there a "natural limit" or "stall point" in the size of the business by industry and country as the entrepreneur attempts to scale up before he or she faces the challenge of their corporate lives to overcome the start of a secular reversal in fortune? After all, if an elephant were larger by a mere 15 percent, its body weight would require such bone and muscle strength in its legs that its weight would make it simply too heavy for the muscles to lift, and the beast, unable to move, would starve.

Yet, elephants can dance, as what Lou Gertsner said in describing how he led IBM to overcome a near-death experience in the early 1990s when he took over as CEO in April 1993. IBM then was at US$10 billion after falling from its 1987 peak at US$50 billion. By reducing the Big Blue's dependency in mainframe manufacturing, which was supplanted by personal computers and servers, and building the global platform for services to provide higher value to customers, a core business which today accounts for over 40 percent of its overall profits, Lou had multiplied the market cap 10-folds to US$100 billion by the time he passed over the leadership baton in 2002 to Sam Palmisano. Palmisano quadrupled earnings and created another US$120 billion in shareholders' value in 10 years as he positioned IBM in software and analytics, an area which now contribute more profits than services do.

Understanding the dynamics of this stall point can illuminate important lessons for both the Asian entrepreneur trying to scale his or her enterprise to a greater height and the diligent value investor wanting to generate sustainable multibagger returns. In other words, value investing is about investing in the outstanding entrepreneur building the durable economic moat which means the business gets easier, not harder, as it gets bigger.

One key to McDonald's success is what Mr. Kwan described: "McDonald's sells a system, not products." The System of People, Products, Place, Price and Promotion. The stability of the "three-legged stool" System of Franchisees, Suppliers and Employees. The System that accumulates knowledge to synthesize the factors of production in land, labor, capital, and technology to scale the business sustainably. Yet, this is perhaps still only less than half the reason. A System requires too many moving parts to work – too much risk involved for a cautious value investor to bet big. There has to be "something", that intangible key switch, to connect the different tangible moving parts such that they reinforce the outperformance of one another in a clockwork fashion, which, if it does succeed, can result in the lollapalooza effect that superdominates the competitors.

The key switch to its enduring success is arguably the culture that Kroc infused right from the start into McDonald's. Kroc believed wholeheartedly in his franchisees and partners to become successful before he does, which has an appealing sense of human justice to it. Kroc was embarrassingly open about his personal finances – what he earned, what he paid for his house, what he owed. That candour carried over into his business. He would fully disclose the costs and prices of McDonald's suppliers so that the franchisees would know that his company was not benefiting from any kickbacks or commissions that were the common practice. Any price breaks from the suppliers were passed directly to the franchisees to improve their competitive advantage. By not indulging in kickbacks, McDonald's showed suppliers and franchisees alike that "it was in the business for the long haul, not the short haul". Kroc once told a supplier: "I want nothing from you but a good product. Don't wine me, don't dine me, don't buy me any Christmas presents. If there are any cost breaks, pass them on to the operators of McDonald's stores."

As copycats sprouted, Kroc was also willing to sacrifice the quick franchising profits others were making in up-front fees collected from selling territorial rights and equipment to franchisees. After making most of his or her money before the store opens, these owners did not care much about the subsequent performance of their franchisee clients. Kroc was also never tempted to make side income, unlike many other operators who have no qualms to jump at any such chances. Kroc steadfastly enforced that there would be no pay telephones, no juke boxes, no vending machines of any kind in McDonald's restaurants. The side income these machines offer would create unproductive traffic in a store and downgrade the family image that he wanted to create for McDonald's.

"This is going to be probably one of the most competitive businesses in the U.S. and we have the only real solid approach to this business," Kroc said with conviction, "The other ones are going to die like flies. They are rackets. They are fast-buck deals. Those fellows [the franchisees] are going to do any doggone thing they want to do, and the owners of the name are just going to let them do anything they want as long as they are getting money out of it. It will be a survival of the fittest, and we are going to be on the top of the list of the fittest. I know we have the only clean, honest franchise."

As a result, McDonald's is able to cultivate a massive base of entrepreneurial long-term dedicated operators and suppliers in a way that rivals cannot because of its long-term culture. A long-term culture that triggers the intense instinct, emotional focus and commitment with regard to actively planning for the enterprise's future as one cohesive singular enterprise and not as separate fiefdoms. A long-term culture which fosters a one-for-all team environment and provide the overarching raison d'être in that everyone feel the pressure from the marketplace to deploy assets and forge strategies that create multibagger entrepreneurs, a common scorecard of sustainable performance.

Aggressive competitors who sold out to major food processing giants to finance their growth find themselves eliminated out of the race. The packaged foods giants belatedly discovered that there was an enormous difference between the management of manufactured food sold to supermarkets and food prepared and sold directly to customers at a fast-food outlet. In the former, manufacturing is centralized and more easily controlled, and the sale to the consumer is indirect and depends highly on branded advertising. In the latter, production is decentralized and difficult to control, since each store is a self-sustaining production unit. Furthermore, the sale to the consumer is direct and depends highly on local service. This is also a lesson for most Asian entrepreneurs who grew their businesses as a manufacturer because it allows them centralization and control – it takes a vastly different mindset to scale services and knowledge-based business models successfully.

Success for the Kroc becomes synonymous with value to society. Success becomes building a durable economic moat and a culture in which everyone knows that they cannot accumulate greater responsibilities and wealth unless they help in cultivating multibagger entrepreneurs. Yet, everyone stayed hungry with a “McHeart” in cultivating more entrepreneurs no matter how much credit they had accumulated because they were in a position to help something truly important live and thrive.

Kroc passed away early in McDonald’s corporate lifecycle at the age of 81 in 1984 – and had worked at McDonald’s nearly every day even when he was confined in his wheelchair until the day he died. He left behind the culture of integrity, candour, teamwork, commitment, and performance-based fairness. Without this, most entrepreneurs will inevitably find themselves operating a tougher business over time as the “system” to scale “the product that may not stand alone on its own” will disintegrate. This is also the reason why most other restaurant retailers, be they from the west or Asia, are not close to one-tenth of McDonald’s size.

The late American writer Carl Sandburg once said, “When an institution goes down or a society perishes, one condition may always be found. It forgot where it came from. They lost sight of what had brought them along”. Whenever McDonald’s was embroiled in controversies that were the result of its neglect of the core values, such as the usage of low-quality or unhealthy ingredients, it flounders. When the Golden Arches went back to rediscover the core values, it rises back up, like it did when it created a healthier and higher-quality image since 2003. Without the workable intangible culture and core values, the tangible assets, such as its vast retail property assets, would amount to a dark-cloud-like ominous liability, particularly when leverage is involved.

McDonald’s is a story about pragmatic romantics, a story about entrepreneurs trying to create a new and better world for people with enduring values. What was motivating Kroc, who was chronically ill before he ever stepped in McDonald’s, was the belief that he had at last found the idea that could be the foundation of the major enduring enterprise he had been hoping to build since leaving the security of his previous company. Kroc developed a sense of mission that pulled his team together because Kroc convinced them that they were involved in a noble undertaking – building a national chain of 15-cent hamburger stands. They shared a common desire to prove to family, friends, and more established businessmen that they were pioneering a new industry that would someday have a far-reaching impact on American life and business – and now the world.

The performance-based economic built by Kroc and his team at McDonald’s gave the ordinary worker the chance to be successful in their own right if they work hard and honestly. It would be interesting if clients and the investing public in the asset management industry are able to get the performance-based treatment enjoyed by McDonald’s franchising partners – no kickbacks, no up-front fees, and the operator genuinely cares about the subsequent performance of the franchisee clients since their success and destiny are inextricably intertwined.

Above all, what should the genuine entrepreneurs and the diligent value investors take to heart? For the elephant to continue dancing, to surpass stall points in scaling new heights, it must have the right McHeart.