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SMART MONEY

# Can They Really Make Money Off the Dollar Menu?

*A look at what the deals really cost and why have they become a battleground for franchisees*

By Diana Ransom SmartMoney

McDonald's "Dollar Menu." Subway's "\$5 Footlong." Quiznos's "Million Sub Giveaway." As the U.S. tries to climb out of the recession, these bargain fast-food meals have become familiar subjects of TV ads and radioingles -- and for many consumers, they are some of the best food values around.

But few of the hungry diners who bite into those discounted subs and burgers realize that their cut-rate meals can be a flashpoint between big fast-food companies and the franchise owners who operate local stores. The promotions are typically decreed by company headquarters, hoping to lure in customers and fend off the competition. These days, however, some franchisees say the costs of offering these deals are too high -- and worse, that penny-pinching consumers drawn by promotions are skipping full-price extras that typically help offset the low margins of the discounted items.



Doni Pitchford, a Subway franchisee in Jamaica, N.Y., says she ran into this issue in February when headquarters unveiled a new pastrami sandwich at New York-area stores. To promote the new menu item, the company issued coupons for a free sandwich -- with

no purchase necessary. Even though Subway supplied Pitchford's store with slices of pastrami, she was responsible for picking up the rest of the tab. The cost of the bread, cheese and other condiments amounted to about \$1.50 to \$1.75 per sandwich, she estimates, and that didn't include the added labor expense she took on just to meet the throngs of customers that gathered in her 1,300-square-foot store.

Making matters worse, the two boxes of pastrami Subway sent Pitchford ran out in just two hours. "When I ran out of pastrami, we couldn't accept coupons anymore. Then our customers got mad," she says. "I don't mind my food costs going up as long as I'm increasing sales. But these people were coming in just for the coupons... It was a nightmare," she says. After giving away 120 sandwiches (half of which were made with her own supply of pastrami) over the two-hour period, she estimates having lost roughly \$500 on the deal. Subway spokesman Mack Bridenbaker, says that although they encourage franchisees to take part in promotions like this one, participation is voluntary and Pitchford could have opted out.

The tension over the recession-driven deals highlights one of the conundrums franchised businesses like fast food must grapple with. By providing a standardized product backed by big national or even global brand advertising, the mother-ship corporation provides franchisees with a way to start a business with a brand that customers already know and trust. But, in return, franchisees must be willing to abide by certain rules and demands from headquarters. That adherence to the home office's policy is critical to the entire approach

since it provides the consistency to customers that assures them that a Burger King Whopper in Olean, N.Y., will taste just like one in Tempe, Ariz. -- even if the stores are run by completely different owners.

That means toeing the line on big regional or chainwide promotions -- even those that cut way into margins on the discounted items. Normally, these promotions can act like a loss leader. But now cash-strapped consumers are often less willing to shell out for extras like French fries and fountain drinks -- items which traditionally receive a lofty markup, says Evan Hackel, a franchise management consultant in Reading, Mass. And that has resulted in some hefty losses for franchise owners.

Yet despite the money-losing proposition, many franchise owners feel they have little choice in the matter: If they forgo the promotion, they risk a backlash from their customers -- and from headquarters. "It's kind of like your arm is twisted into participating," says Romil Patel, a Baskin Robbins franchise co-owner in Milwaukee.

A recent KFC promotion actually sparked protests among customers. In early May, KFC president Roger Eaton, appeared on the Oprah Winfrey show and announced that participating stores were accepting coupons for a free two-piece grilled chicken meal through May 19. Stores across the country became overwhelmed and could no longer honor the coupons. In New York, a sit-in ensued at the 42nd Street Times Square location when the manager told customers that the store would not honor any more coupons that day. (The Riese Organization Corporate Group, the owner of the 42nd Street store, declined to comment.)

Still, KFC corporate says the promotion was a big hit. "Ten and a half million coupons were downloaded in just over 24 hours, and more than four million [coupons] were redeemed in the first two days of what was scheduled to be a two-week redemption window," says Rick Maynard, a KFC spokesman. The promotion only lasted for two days following the Oprah show announcement. Coupon holders who weren't served during that period were given rainchecks to be redeemed at a later date. The company also threw in a complimentary soft drink.

Beyond drawing the ire of unsatisfied customers, franchisees also risk falling out of favor with the mother ship, says Christopher A. McElgunn, a franchise attorney in Wichita, Kan. Franchisees who aren't deemed in good standing by the franchisor risk receiving less-favorable pricing for equipment and supplies, and missing out on expansion opportunities, he says. "It's up to the discretion of the franchisor," says McElgunn.

Sometimes, franchisees have no choice in the matter. While it doesn't happen often, franchisors can make participation in their promotions mandatory. Thanks to two separate Supreme Court rulings: *State Oil Co. v. Kahn*, and *Leegin Creative Leather Products, Inc. v. Kay's Kloset*, franchises are now able to set price minimums and maximums for their stores, says Robert Zarco, a franchise attorney in Miami. If franchisees refuse to participate when price promotions are mandatory as per their franchise agreement, they could lose their franchise or risk being sued by the franchisor for breach of contract, says Zarco.

So how much money are local stores making -- or losing -- on some of these deals? To find out, we surveyed franchisees about some popular current and recent promotions. On top of paying royalties (of about 11% to 12% of sales) to the franchisor, franchisees often bear the brunt of a promotion's cost. We also asked franchisees about their wholesale costs for food, as well as labor, rent and utilities, among other things. Prices and menu for a particular promotion also vary depending on location.

### *Baskin Robbins*

**Promotion:** 31 Cent Scoop Night - This annual promotion occurred between the hours of 5pm and 10pm on April 29.

**What they normally charge:** \$2.29 (one single scoop)

**Promotion Price:** 31 cents

**Bottom line for restaurant:** Loss of roughly \$1.45 a scoop

Baskin-Robbins' 31 Cent Scoop Night is done in the name of charity. Not only does the company donate \$100,000 to NVFC National Junior Firefighter Program, but it's also quite generous to ice cream lovers as well. One scoop (of any flavor you choose) for just 31 cents compared to the regular price of \$2.29 at one location in Wisconsin is a pretty sweet deal. Franchisees don't feel much of that goodwill, however: Beyond the approximate 60-cent cost of the ice cream, a spoon and a cup, store operators also pay another \$1.15 per scoop for rent, utilities and labor, estimates one store owner in Wisconsin. Baskin-Robbins spokeswoman, Danielle Sullivan, says the company's own calculation on per-item profitability differs from those provided to us by franchisees, but she declined to give specific figures. She also declined to comment further on costs and profits.

### *Little Caesars*

**Promotion:** HOT-N-READY Pizza - Get one 14-inch large cheese or pepperoni pizza for \$5 at participating locations.

**Pre-promotion price:** \$10.99 (one large one-topping pizza)

**Promotion Price:** \$5

**Bottom line for restaurant:** Profit of roughly 90 cents a pizza

Introduced six years ago, Little Caesars HOT-N-READY Pizza promotion offers 14-inch cheese and pepperoni pies for just \$5. Even though some stores charge about 55 cents more than that, margins are still slim. The cost of a single pizza's ingredients and packaging amounts to about \$3.50, according to a franchise operator in Georgia. Tack on another 60 cents for rent, labor and utilities and franchisees earn roughly 90 cents a pie. Little Caesars' spokeswoman Colleen Kmiecik says the company's own calculation on per-item profitability differs from those provided to us by franchisees, but she declined to provide specific figures. She also says the company provides long-term profitability information to its franchisees to show how the promotion will boost their bottom line, but would not provide further details.

### *McDonald's*

**Promotion:** Dollar Menu - McDonald's customers may purchase a number of items, including French fries, an ice cream sundae, a four-piece chicken nuggets and a double cheeseburger for a dollar each.

**Pre-promotion price:** \$1.50 (double cheeseburger)

**Promotion Price:** \$1

**Bottom line for restaurant:** Profit of roughly 6 cents a burger

The McDonald's Dollar Menu may be the best value in town, but some franchisees find the six-year-old promotion hard to stomach. While food and packaging costs just 45 cents for a double cheese burger, franchisees also have to pay for rent, labor and utilities. In total, a promotional price of just \$1 leaves store operators with a measly 6 cents of profit, according to a franchisee in Florida. Of course the markup on fountain drinks and French fries is typically pretty high. However, many consumers these days are forgoing such add-ons. McDonald's did not immediately return phone calls and emails seeking comment.

### *Quiznos*

**Promotion:** Million Sub Giveaway - The first million people to register for Quiznos's Q Club received a coupon good for any sandwich. (Certificates for this promotion expired by March 15, 2009.)

**What some stores normally charge:** \$5.29 (one six-inch chicken sandwich)

**Promotion Price:** Free

**Bottom line for restaurant:** Loss of roughly \$2.25 a sandwich

"The response to Quiznos's Million Sub Giveaway was tremendous -- with all one million free sub certificates requested within three days of the launch," says a Quiznos spokesperson. While Quiznos claims to have reimbursed franchise owners for food and paper costs, which amount to roughly \$2.25 for, say, a chicken sandwich, other costs including rent, utilities and labor fell to individual franchisees -- leaving some franchisees with an average loss of roughly \$2.25 per sandwich, according to a franchisee in Maryland.

### *Subway*

**Promotion:** \$5 Footlongs - The chain offers any regular sub for \$5. (Which subs getting this price tag will vary by store.)

**What they normally charge:** \$5.89 (12-inch turkey sub)

**Promotion Price:** \$5

**Bottom line for restaurant:** Profit of roughly \$1.20 a sandwich

The \$5 Footlong is a catchy marketing slogan but the discounting on the turkey sub isn't as deep as some other big fast food promotions. For Subway operators you can still eke out a decent per item profit -- and hope the diner is thirsty for a large, high-margin soda. To make the footlong turkey sub, the ingredients cost \$1.65 at a New York location. Mack Bridenbaker, a Subway spokesman, declined to discuss the economics of hosting the company's \$5 footlong promotion.

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