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HBR. ORG THE GLOBE NOVEMBER REPRINT R K KFC's Radical Approach to China To succeed, the fast-food giant had to throw out its U. S. business model. by David E. Bell and Mary L. Shelman With compliments of... The Globe At a KFC in Beijing KFC's Radical Approach to China G PHOTOGRAPHY: GETTY IMAGES To succeed, the fast-food giant had to throw out its U. S. business model. by David E. Bell and Mary L. Shelman 2 Harvard Business Review November 2011 lobal companies face a critical question when they enter emerging markets: How far should they go to localize their o erings? Should they adapt existing products just enough to appeal to consumers in those markets? Or should they rethink the business model from the ground up? The typical Western approach to foreign expansion is to try to sell core products or services pretty much as they've always been sold in Europe or the United States, w ith headquarters watching closely to make sure the model is exported correctly. This often starts with selling imported goods to the expat community or opening one or two stores for a trial run. Once such an approach is entrenched, companies are reluctant to rethink the model. U. S. retailers and food corporations that have spent years saturating the huge home market tend to cling to what has worked in the past. Domino's Pizza nearly failed in Australia because it underestimated the need to adapt its offerings to local tastes; only after it turned the country over to a local master franchisee did Domino's become the largest pizza chain there. A master of adaptation is the Swiss food giant Nestlé, which has created an array of products that incorporate differing regional avors–and cater to local tastes–in co ee, chocolate, ice cream, and even water. For a hundred years Nestlé's country FOR ARTICLE REPRINTS CALL OR , OR VISIT HBR. ORG KFC

China’s Blueprint for Success managers have been empowered to say no to the head o ce if a product or a campaign doesn’t suit their locales. Perhaps the greatest tribute to the strategy is that many consumers around the world believe Nestlé is a local company. One of the most impressive stories of a U. S. multinational in an emerging market is unfolding right now in China: KFC is opening one new restaurant a day, on average (on a base of some 3, 300), with the intention of reaching 15, 000 outlets. The company has achieved this success by abandoning the dominant logic behind its growth in the United States: a limited menu, low prices, and an emphasis on takeout. We recently studied KFC China’s transformation of the business model that had made Kentucky Fried Chicken a global brand, and we learned how, in the process, the company accumulated strengths and competencies that now pose formidable barriers to competitors. KFC China o ers important lessons for global executives who seek to determine how much of an existing business model is worth keeping in emerging markets and how much should be thrown away. Five Competitive Advantages In 1987, when the rst Chinese KFC opened in Tiananmen Square, Western-style fastfood restaurants were unknown in China. Many Chinese still wore the tunic suits of the Mao era, and bicycles were the main means of transportation. KFC was a novelty, a taste of America. It was a place where residents with spending money could go for a special occasion. Although customers didn’t like the food much, KFC made steady progress, according to Sam Su, now the chairman and CEO of Yum! Brands China Division, which owns KFC and a number of other brands in the country. In 1992, after the Chinese government granted foreign companies greater access to markets, KFC China’s managers gradually

developed the blueprint that would transform the chain. Like every other multinational in China, KFC made its way up the learning curve by trial and error. But the strategy that emerged was remarkably clear and embodied five truly radical elements: turning KFC into a brand that would be perceived as part Chinese; expanding rapidly into small and midsize cities; developing a vast logistics and supply chain organization; extensively training employees in customer service; and owning rather than franchising the restaurants. KFC China's executives believed that the company's U. S. model, although good enough to do moderately well in the largest Chinese cities, wouldn't lead to the level of success the company sought. They understood that in China, as in many other developing countries, food is at the very heart of society, inextricable from national and regional cultures, and that an abundance of avors and an inviting ambience would be necessary to win over consumers in great numbers. Execution of the strategy turned on a fluke of corporate ownership. With a closely involved parent, KFC China might not have been free to pursue its homegrown strategy. But the chain was then a unit of PepsiCo, which took a hands-off approach–it was more concerned with beating Coca-Cola than with selling fried chicken. As long as KFC China's nancial results were good, PepsiCo was happy. Su (who joined KFC China in 1989) created a knowledgeable, motivated top management team, hiring ethnic Chinese and painting a scenario they could believe in: T he company they would build would make China a better place. KFC China's menus typically include 50 items, compared with about 29 in the United States. KFC China's success in winning over Chinese consumers grew out of a deep understanding of the

diï¬€erences between established and developing markets and a willingness to radically alter the U. S. business model. KFC's approach may not apply across the board, but it suggests a mind-set that can position multinationals to win in emerging markets. KFC China's five competitive advantages all depart from the U. S. model. Infusing a Western brand with Chinese characteristics. The company's managers sought to stretch the brand so that consumers would see KFC as part of the local community–not as a fast-food chain selling inexpensive Western-style items but as restaurants offering the variety of foods and the traditional dishes that appeal to Chinese customers. They enlarged the outlets, which are about twice the size of those in the U. S., to allow for bigger kitchens and more floor space where customers can linger. They made a special effort to welcome extended families and groups. In the United States, by contrast, KFC outlets are designed primarily for takeout–most of the dining is done at home. KFC China's menus typically include 50 items, compared with about 29 in the U nited States. The menu variety adds traffic and encourages repeat visits. The company introduces about 50 new products a year (some of them are o ered only temporarily), compared with one or two in the U. S. Its executives have what they consider to be a very aggressive program for new product development, which is handled by a committee of managers from m arketing, operations, product safety, and the supply chain. Menus offer spicy chicken, rice dishes, soy milk drinks, egg tarts, fried dough sticks, wraps with local November 2011 Harvard Business Review 3 THE GLOBE LOCALIZE OFFERINGS BY COUNTRY AND REGION. MOVE QUICKLY TO ESTABLISH A BROAD PRESENCE. In an eï¬€ort to please local consumers, the company reinvented its menu and

varied spiciness levels from region to region. KFC established 16 beachheads as a way of quickly expanding throughout the country. TAKE CHARGE OF THE SUPPLY CHAIN. In the absence of logistics providers, KFC China created a distribution system to ensure adequate and highquality supplies. sauces, and fish and shrimp burgers on fresh buns. Spiciness levels are very important to customers. In the chain’s early days, when the same recipes were served at all outlets, Shanghai customers complained that dishes were too hot, while diners in Sichuan and Hunan complained that they were too bland. So the company changed its recipes to suit the regions. It also o ers congee, a popular rice porridge that is hard to make at home, which is KFC’s number one seller at breakfast. The extended menu means that food preparation is more complex in Chinese KFCs than in American ones and requires more hands (thus the bigger kitchens). These outlets typically employ 60 people–nearly twice as many as in the U. S. Often one of those employees is a hostess who greets customers and organizes pastimes, such as learning English songs, for young children in play areas. With all this activity to support, KFC c an’t position itself as the cheapest dining option–nor does it want to. Customers spend the equivalent of $2. 50 to $3. 50 per visit, a price point that puts KFC way above street vendors and local restaurants and even somewhat above other fast-food chains. Although young “ white collars" in Shanghai might eat a KFC lunch with friends once or twice a month, a family in a smaller city might go once or twice a year, to celebrate a special event. 4 Harvard Business Review November 2011 BECOME A LEARNING ORGANIZATION. Across the company, from logistics to food preparation to customer service, employees require extensive training, and experienced

managers must be constantly developed as the company grows and changes. MAINTAIN FLEXIBILITY. Focusing on owned restaurants rather than franchises enabled the company to make changes where necessary to meet local needs. Expanding rapidly. Rejecting the measured growth of its China competitors and of KFCs in other countries, KFC China set its sights on rapid expansion. One factor in this decision was the presence of McDonald’s in China’s four largest cities. Rather than go head-to-head with the Big Mac, KFC decided to embrace smaller cities and to build a national business with outlets all over the country. Scale allows the company to reduce costs, and being the rst to enter a city means getting the pick of locations with good foot tra c and visibility. Being first also means garnering free publicity when o cials celebrate an outlet’s opening as marking the city’s coming of age. Moreover, a national presence means that KFCs (and other Yum! outlets) are popular with mall developers. KFC rushed to establish a presence in 16 locations from which it could grow and develop. By 1999 it was opening dozens of restaurants a year, and in 2002 it picked up the pace even further. (In 2008 Yum! Brands’ annual opening rate in China surpassed 500 restaurants, most of them KFCs–compared with 103 new KFCs in the United States.) From site selection to grand opening, it takes KFC China four to six months to bring a new restaurant into the world– about half the time required in the U. S. Some 700 Chinese cities now have outlets. With KFC as its agship chain, Yum! has become China’s largest restaurant com- GUARD AGAINST BACKLASH. Concern in the West over high-fat, high-carbohydrate foods prompted the company to begin changing its menu and educating consumers about health. pany by far, with more than 250, 000 employees

and about 40% of the market for fast-food chains. KFC’s rapid expansion in China has allowed the company to widen the gap between itself and competitors: McDonald’s has about one-third as many outlets and owns a 16% market share. Developing a logistics network. In the United States and Europe, fast-food chains rely on networks of distributors to ensure that food is handled properly and kept refrigerated from the farm to the restaurant. No such networks exist in many of the world’s emerging markets. To meet this challenge, KFC China established a distribution arm in 1997, building warehouses and running its own fleet of trucks. This was an expensive undertaking, but necessary if the company was to expand rapidly, carry a lengthy and complex menu, and introduce new products quickly. That same year the company implemented a sup plier rating system that allows managers throughout China to concentrate purchasing with the suppliers that perform best. Food safety is a matter of paramount importance, especially given Chinese consumers’ concern in recent years over incidents involving tainted milk powder and contaminated livestock feed. KFC China had a brush with this issue a few years ago, when a colorant that had been linked to cancer was found in one of the company’s sauces. Although the problem was resolved FOR ARTICLE REPRINTS CALL quickly, Yum! China reported a resulting 30% drop in operating pro t in the second quarter of 2005. KFC China closely monitors the entire supply chain, all the way back to animal feed companies and other input providers, and it trains employees in personal hygiene, including how to dress for the workplace and how often to wash their hands. It now has the most advanced and integrated cold-chain system in China, with 11 fullservice logistics centers and six satellite c enters

serving every province except Tibet. To circumvent the tra c jams that sometimes extend for miles in the winter, it relies on contingency plans that involve renting temporary warehouses and reserving space on cargo airlines. Most products are sourced in China. Buying locally is essential to keeping costs low, and it strengthens the parent company's relationship with the Chinese gov- ernment. The policy has a few unavoidable exceptions, including certain herbs and spices–for KFC's " secret" fried chicken recipe–that can't be obtained in China. But the company works with its suppliers to build their capabilities and capacity; it is even working with growers to introduce U. S. varieties of sweet corn. Training employees in service. When KFC opened in Beijing, it was one of the first companies to promote excellent c ustomer service–a concept then unfamiliar in China after decades of commu- New recruits at KFC often have to be taught basic people skills in order to interact with customers. OR nism. But despite an abundance of willing workers, sta ng is a perennial obstacle. In fact, it is the limiting factor in the chain's expansion, according to Sam Su. To maintain its current restaurant-opening rate, KFC needs at least 1, 000 new managers and 30, 000 new crew members a year, and they must be ready the minute an outlet opens, because it is likely to be packed. The company prides itself on being a " learning organization. " Teams of new employees work side by side with experienced ones in established outlets; once trained, they move to a new location. Teaching employees how to interact w ith customers is no small matter. Onechild families and the proliferation of home computers mean that Chinese children interact less with other people than they did in previous generations. New recruits at KFC often have to learn basic people skills and

teamwork. The Chain Restaurant Landscape in China Ever since KFC China opened its ï¬�rst outlet, in Beijing in 1987, the number of foreign-owned chain restaurants has grown steadily in China. Here’s a look at some of them. BURGER KING has about three dozen restaurants in China, where its ï¬�rst outlet opened in 2005. In 2010 an executive said that Asia would be the brand’s largest growth engine within three to ï¬�ve years but that BK planned to proceed cautiously in China. DAIRY QUEEN has some 300 Chinese outlets. MCDONALD’S opened its ï¬�rst restaurant in China in 1990 and plans to double the number of outlets there to 2, 000 by , OR VISIT HBR. ORG TACO BELL was similarly 2013. The company says its strong sales in the Asia/ Pacïï¬�c, Middle East, and Africa regions are led by results in China, and it cites the appeal of such conveniences as delivery, drive-through, and extended hours. Some 70% of McDonald’s Chinese outlets are open 24 hours a day. some 500 dine-in restaurants and 120 delivery-only outlets. Like KFC, it has undergone a transformation in China. It now oï¬€ers a lengthy menu that includes seafood pizza, beefsteak, and fried squid, and it attracts an older and more aï¬„ uent crowd than KFC does. PAPA JOHN’S plans positioned by Yum! as an upscale restaurant, but it was shut down in China after a ï¬�ve-year experiment. Mexican food, with its emphasis on dairy and beans, didn’t appeal to Chinese consumers. STARBUCKS opened in to increase the number of its outlets in China from 155 to 300 within three years. PIZZA HUT is a part of the Yum! portfolio; it has WENDY’S ARBY’S has only about 300 restaurants outside North America. It announced earlier this year that it was considering expansion in China. China in 1999 and has about 450 shops there; the company plans to have 1, 500 by 2015. Executives say

they believe there is huge potential to drive coï¬€ee consumption in China. November 2011 Harvard Business Review 5 THE GLOBE FOR ARTICLE REPRINTS CALL OR , OR VISIT HBR. ORG Taking on a New Challenge: Chinese Food Many other companies have followed KFC's example in customer service (last year McDonald's announced that it was opening a Hamburger University in China), but KFC's training program functions exceptionally well, churning out a continual stream of new managers. This, like the company's extensive logistics network, is an advantage that is di cult for any competitor to emulate. Focusing on ownership rather than franchising. In KFC's early days, China required foreign companies to have local partners; but when the country became more receptive to wholly owned foreign enterprises, KFC China switched to a strategy of company-owned outlets–another way in which it challenged the dominant logic. (More than 90% of Yum!'s outlets in China are company owned, compared with 12% in the U. S. and 11% in other international markets.) Franchising has long been a mainstay of the fast-food industry, because it reduces investment costs and risk and enables rapid geographic expansion. It works well when a pool of experienced, entrepreneurial candidates are available to run franchises and when restaurant operations are relatively simple–built around, for example, a limited menu of easy-to-make products. But KFC China's model was more complex and evolving rapidly. Owning the restaurants allows the company to closely control every aspect of their operation, from menu to decor, and to monitor results and the success of new products. It permits centralized purchasing, which reduces costs, and gives the company a larger share of outlet pro ts. The Risk of a Backlash KFC China's rapid growth poses

challenges: A highly visible company could easily become the target of a consumer or government backlash against the perceived negatives of fast food. Some Western health problems are already showing up in China. The 2002 China National Nutrition and Health Survey revealed that 22. 8% of Chinese adults were overweight, up from 6% in 1982. The number of overweight and 6 Harvard Business Review November 2011 Yum! China’s strengths in service, logistics, and training have positioned the company to support additional restaurant formats, including a local one with which it had no experience: Chinese fast food. In recent years Yum! has experimented with developing East Dawning, a chain that takes its name from a line in an ancient Chinese poem. The clean, eï¬ƒciently run restaurants have Chinese decor and serve Chinese food exclusively–no U. S.-style fried chicken, no pizza, no burgers. The chain, which opened in Shanghai in 2005, oï¬€ers such favorites as beef rice and bean curd at prices similar to KFC’s. Yum!’s initial hope was to create a large national chain, but Chinese food poses signiï¬�cant challenges in a fastfood context: Noodles and vegetables must be prepared just before serving; customers are highly discerning about freshness and traditional ï¬‚avors; and tastes vary widely across regions. The chain has relatively few outlets, and nationwide expansion is still a distant goal. Recently, Yum! has focused on acquiring a competitor, Little Sheep, a Hong Kong—listed chain of hundreds of Mongolian-style hot-pot restaurants. By 2010 Yum! held a 27% stake in Little Sheep, and earlier this year it proposed to increase its ownership level to 93%. obese children aged seven to 17 has tripled to 8. 1% over the past 10 years, according to the same agency. In the mid-1990s a fellow participant at a seminar in the U. S.

asked Su why he would want to bring “ junk food" to China– a question that started him thinking deeply. Aware of a growing sense in the West that high-fat, high-carbohydrate foods play a role in the obesity epidemic, Su asked himself how Yum! Brands could take action to forestall such problems in China. In 2005 the company developed the concept of a “ new fast food" that would be “ nutritious and balanced" and promote “ healthy living. " It eliminated “ supersize" items and added roast chicken, sandwiches, sh, shrimp, and more fruit and vegetable dishes to its menus. KFC’s children’s meals are served with vegetables and juice, although fries and soda can be substituted on request. Tray mats carry educational messages. Nutrition information is printed on every package. Hostesses teach lessons on nutrition to kids. A Conï¬�dent, Dynamic Company The results of the strategy of heavy localization have been impressive: In the first half of 2011 sales at Yum! China locations that had been open a year or more rose 16%, compared with a decline of 2% at U. S. locations. The restaurant margin for those six months was 22%–well above the U. S. margin of 11%. Yum! China revenues and operating pro ts in 2010 were $4. 1 billion and $755 million, respectively; comparable gures for the overall company were $11. 3 billion and $1. 77 billion. The third quarter of 2010 marked the first time that China revenue (more than $1. 1 billion) had surpassed U. S. revenue, and many analysts expect that Yum!’s China business will be twice as large as its U. S. business within ve years. Over time, KFC China has come to reect China itself in some respects: It is large, growing, con dent, and eager for variety and new experiences. Most of all, it is, like China’s economy, dynamic and capable of expanding still further–at a remarkable pace. Much of what the

company has accomplished is the result of its homegrown strategy–and of the independence that PepsiCo gave Su and his leadership team in the early days. If there is an overriding lesson to be drawn from KFC’s experience in China, it is that when entering an emerging market, a multinational must decide whether it wants to garner quick extra sales or to establish a long-term presence. If it’s there for the long haul, it should install local managers whose vision is to build an organization that will last. HBR Reprint R K David E. Bell is the George M. Moï¬€ett Professor of Agriculture and Business and a senior associate dean at Harvard Business School. Mary L. Shelman is the director of the Agribusiness Program at Harvard Business School.