# Dunkin' Donuts – the birth of a new distribution and franchising concept

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**Dunkin' Donuts is a global retailer of coffee and bakery products. The company is 99 per cent franchised and has used the franchising system as a route to market entry and expansion worldwide. The original historic roots of the company are in the USA and despite wide international expansion since the 1970s, the US market continues to serve as a testing ground for innovations prior to international roll-out. Based on observation and key informant interviews with core members of the management team during a visit to Richmond Project in 1994, the case explores the initial phase of the introduction of a central production facility as an innovative route to pre-eminence in one test market. Strategic and operational issues are discussed, highlighting the differences and efficiency gains of the central production facility cum satellite store approach compared to the traditional stand-alone on-site production approach. Implications for future developments are discussed.**

**This case is based on information obtained in the autumn of 1994 and should be interpreted on the basis of information available to management at that time.**

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## Introduction

Dunkin' Donuts is a wholly owned subsidiary of Allied Domecq plc which operates worldwide, making and selling coffee, doughnuts, and other related bakery products. Founded in the USA in 1950, the business started international expansion in 1970, was acquired by Allied Domecq in 1990, and is now the world leading retailer in its field.

The company mission statement clearly sets out a continued emphasis on growth and market leadership: "Our dream for the future is to be among the world's most recognized and respected brands. To accomplish this, we are passionately committed to pursuing the following values in every interaction with all those whom our system touches:

- trust and integrity;
- teamwork;
- continuous improvement and learning;
- joy.

Our mission is to be the pre-eminent retailer of high quality coffee, doughnuts and related bakery, snack, and beverage products in each market in which we compete. In addition, we wish to be pre-eminent retailers in these product categories as measured by total sales versus any of our competitors throughout the USA."

In the USA alone, Dunkin' Donuts currently generates an annual sales volume of $1.4 billion. Pre-eminence in a local market is defined as 4.5 per cent of consumer expenditure on fast foods and multi-media advertising expenditure to match the cost of 44 weeks' TV exposure. The number of distribution points needed to achieve this is based on the area population and advertising. Each store contributes 5 per cent of sales revenue to corporate advertising. Currently the national sales average is $10,500-$11,000 per store per week. However, where pre-eminence is achieved, sales can go up to $17,000 per week.

Dunkin' Donuts has already accomplished pre-eminence in some parts of the USA, e.g. the Boston area surrounding the corporate headquarters. The experience of operating in these areas serves as a yardstick to set targets for other areas currently striving for pre-eminence. A rapidly changing environment and strong competitive pressure from other fast food operators serve to stimulate the corporate management team to strive to be innovative in experimenting with alternatives to organic growth. The aim is to identify and test ways of accelerating the achievement of pre-eminence. Ultimately the goal is to develop those paths which prove successful into new franchise opportunities.

## Business format franchising

The Dunkin' Donuts' chain is 99 per cent franchised. Each franchised outlet pays 4.9 per cent of total sales revenue to Allied Domecq plc. Traditionally, site selection has always been very much in the hands of the franchisee. The franchisee typically finds the site, does all the work to evaluate the proposed site's potential, making use of Dunkin' Donuts' "location data report" which is a vehicle containing all the company's criteria for site evaluation. This is then presented to the development manager whose responsibility it is to verify the report. The franchisee is responsible for negotiating the lease with the landlord and then works with the Dunkin' Donuts' construction managers to work out plans for the store and to construct the facility. Historically, the Dunkin' Donuts concept has operated on the basis that doughnuts are manufactured and sold on the franchised premises. Prospective franchisees spend six weeks at the Dunkin' Donuts University, where they learn bakery and equipment handling skills, and receive training in quality control, health and safety, human resource management and basic accounting skills.

Even though Dunkin' Donuts features the advantages of having the back-up and economies of scale associated with a strong franchisor, the responsibility of managing and building the business is essentially retail driven. In the USA, the Dunkin' Donuts system organises the franchisees into 65 districts and six zone advisory councils. Operating standards, sales and profitability goals are agreed between corporate management and the zone advisory councils and communicated to the other franchisees through newsletters, shop visits and meetings. A key determinant in the power balance between franchisee and franchisor is the fact that the buying of raw materials is controlled by the franchisees. Negotiations are carried out through co-operatives owned and operated by the franchisees on a regional level and five regional distribution centres are now in operation in Mid-Atlantic, Midwest, Canada, Northeast and Southeast.

## New routes towards pre-eminence – the Richmond project

Innovation of the basic business franchising format formula and the rigorous testing of new, potentially faster routes towards pre-eminence are central to Dunkin' Donuts corporate development strategy. In this, Richmond, Virginia, currently serves as a test market for the USA. Currently some way off pre-eminence, Richmond was selected for three key reasons. First, it is close to the Boston head office and therefore relatively easy to monitor. Second, labour availability is good and labour costs are relatively low, and third, advertising costs are low.

The aim of the Richmond project is to test out an accelerated path towards market pre-eminence, achieving full market penetration via a predetermined number of satellite distribution points linked to a central production facility (CPF) and to maximise profitability through joint site developments with Baskin-Robbins.

The project's goals are to satisfy customer demand, to achieve and surpass break-even and to run a network of 25-30 stores. In October 1994, 11 outlets were up and running. It is projected that the project as a whole will reach break-even point in October 1995. Pre-eminence in the Richmond area will involve the opening of initially 25 distribution points within 40 minutes drive of the CPF, generating annual sales of $9m. This should be the case by 1997. Combination stores, featuring both Dunkin' Donuts and Baskin-Robbins will be used to maximise returns on the prime sites acquired for the project. It is projected that around 30-35 outlets can be opened and supplied by the Dunkin' Donuts CPF without market saturation being reached. Until a full evaluation of the project's outcomes is possible, it is thought best that all retail outlets involved should be company owned and controlled. Corporate forecasts indicate that the central production concept can develop a market to pre-eminence in half the time it would take via the traditional route.

## Competition

In the drive towards pre-eminence in the Richmond area, Dunkin' Donuts have to compete on two key fronts, coffee and doughnuts.

In markets where Dunkin' Donuts have already achieved pre-eminence, such as the Boston area, coffee sales are around 70 per cent of total turnover, as compared to areas like Richmond where coffee sales are only 10-12 per cent of turnover. Dunkin' Donuts' development manager explained "I am from Richmond and I have always seen Dunkin' Donuts' image as doughnuts. If I wanted a coffee I would go to the 7-11". This historically distinct difference in image is reflected by the sales of Dunkin' Donuts' doughnuts as a branded product in 7-11 outlets, alongside their own flavoured coffee varieties. To overcome the image created by the Dunkin' Donuts name and to achieve increased coffee sales, corporate advertising focuses on coffee. To enhance competitiveness on the coffee side of the business, Dunkin' Donuts is currently experimenting with the introduction of a self-service concept at selected sites in the Richmond area. The self-service concept matches current 7-11 practice and allows the use of "express" queues at busy times.

On the doughnut side, the main competitor in the Richmond area is Krispy Kreme, a nationwide operator, who mainly concentrates on the wholesale side. For Dunkin' Donuts, 98 per cent of their business is on the retail side, for Krispy Kreme, 80 per cent of turnover reflects wholesale trade to retail outlets and supermarkets. Krispy Kreme doughnuts differ from the Dunkin' Donuts product in that they are sold hot, contain preservatives and are smaller, sweeter and lighter. Krispy Kreme's main advantage lies in the economies of scale generated through the use of larger scale production facilities geared to supply the wholesale side of the business as well as the relatively much smaller retail side. However, Krispy Kreme's company owned outlets are generally of an older type (around 20 years old). They are designed to let the retail customer see the back shop factory through a glass partition. By comparison, in a typical Dunkin' Donuts shop the customer only sees the front-stage display, production in the back room remains invisible and is geared to production for the one outlet only.

## The central production concept

In Richmond the centralised production concept was developed as a unique way of matching and surpassing the economies of scale enjoyed by competitors such as Krispy Kreme, and driving growth through retail sales at the same time.

The Richmond central production facility is a large scale doughnut factory, also known as the "kitchen". The kitchen opened in February 1994 and is located in the north-west of midtown Richmond. Having such a central facility allows Dunkin' Donuts to develop retail-only sites and at the same time maximise economies of scale in production, advertising and equipment costs. The benefits of greater centralisation are reflected in tighter staffing and greater control over monitoring and responding to issues of operations costs. The key factors noticeable when examining the central production facility and comparing it with the traditional Dunkin' Donuts shop are the scale and degree of automation of operations resulting in low labour intensity. This is illustrated by the fact that a special order from a high school for 200 dozen glazed doughnuts which would have taken all day to complete if manufactured on the retail premises takes only 20 minutes to complete in the "kitchen".

## Communication and control

The distribution points communicate with the kitchen via the shop information system (SIS), which links the whole network of Dunkin' Donuts facilities and forms an important link in the processes of forecasting, budgeting and control.

Current targets for project management focus on enhancing product quality, building branded business, controlling labour costs and controlling food costs by keeping wastage down. For budgetary control purposes, the kitchen is treated as a profit centre in its own right. At the outset a model budget for the kitchen was drawn up which is now constantly adjusted in the light of real results. The CPF budget for the next financial year is set in a bottom up/top down process by the production and distribution manager who passes it to Dunkin' Donuts' head office in Boston. They in turn pass it on to Allied Domecq. It is then returned through the same hierarchy with amendments to fit the corporate master budget.

In the stores, control issues mainly focus on labour targets and wastage. In addition, for each store certain items are projected as fixed $ amounts, including cleaning expenses, repair and maintenance, uniforms, office expenses, till discrepancies, etc. The aggregate annual budget for the retail side of the Richmond project is set by the district retail sales manager in conjunction with the real estate and development manager. However, while there are projections which form part of the master budget for the project as a whole, there are no budgets as such for the individual stores, owing to lack of experience of what the actual costs are really like. This is counteracted by close monitoring, making use of the SIS information. Daily delivery reports are printed out to allow the supervisor to monitor sales of individual product lines. The shops' orders are based on a combination of last year's figures and the orders from the previous week and day. Units can print out in the shop what their order for the next day should be. The retail multi-unit manager uses the print-out as the basis for this forecast, but can amend it to take local information into account, e.g. a forthcoming football match in the area etc. This information is summarised to give the kitchen a complete production order for each product line. In the kitchen, the production process is activated by the completely aggregated information from the shop information system as to the total production of each type of doughnut required for the shift.

In addition, for each shop, a daily SIS report shows the sales projected and generated for the day. It also compares labour hours projected for the day with those actually spent and draws the supervisor's attention to those employees who are coming close to overtime. A weekly sales report for the units involved in the project is produced once a week. This is based on a handwritten summary produced by the managers, which is a method that is thought to ensure that managers will spend time on and pay attention to this important area. On the basis of figures to date, the team is currently in the process of drawing up budgets for the next financial year. Once approved, the shop budgets will be fine-tuned every week on the basis of the latest incoming information.

On the retail side as well as on the production side, the project has placed emphasis on the streamlining of operations. Traditionally, one manager has been responsible for one freestanding outlet and one cart in a petrol station. For the project, this has been replaced by a system in which a multi-unit manager (MUM) is responsible for three to five freestanding outlets. Each location has one supervisor and around eight employees. Also there is one supervisor for every three carts. The MUM is responsible for the administration of correct company procedure and staff development and coaching. The supervisor is in charge of hiring employees, completing the orders via the shop information system, working with the MUM in implementing disciplinary procedures and monitoring wastage on the different product lines.

Both the cost structure and the nature of the jobs have been altered. For the traditional outlets, shop staff carried out a dual function, as they were involved in both production and retailing. For the project's retail-only sites, the focus is exclusively on customer service. Each member of staff carries out all the work processes required to deal with any given customer. The customer is the guest. However, at busy times, spontaneous team work helps to streamline the job. Staff do things for each other as they notice them. This works best where staff succeed in accepting each other for what they are, finding ways of being productive together and making the most of each other's complementary strengths and weaknesses. Often this is an organic and spontaneous process which takes place without the participants even consciously realising it.

To monitor the quality of service provided to the customer, there is a regular mystery shopper programme aimed at providing feedback. A standard form called the shop assessment guide (SAG) has been designed, based on a customer perspective to be used in quarterly shop visits. Such shop visits are carried out for franchised and corporate owned outlets. In the franchised shops the mystery shopper visit is a form of peer group assessment. A franchisee also contributes to the shop visits of the corporate stores, to assure mutual trust and a level playing field. This system has evolved to counteract some initial potential for friction surrounding the mystery shopper audit. Dunkin' Donuts' management recognise that the budgetary control process can have a strong motivating impact if used correctly. It is intended that as soon as the budget is in place, a performance based bonus programme will be designed and implemented.

While traditionally food costs were largely determined and controlled through the production process which took place on the premises, for the retail-only stores food cost is split into two items, food production cost and food usage cost. From the retail outlet's point of view, food production cost is the charge from the kitchen at transfer prices, plus wastage costs. The cost of purchasing the product from the kitchen is semi-variable, there is a minimum spend which is required to fill the shelf space available and offer the customer reasonable choice. Slightly higher wastage levels mean higher food production costs for retail-only outlets. To try to reduce this, the company is currently also experimenting with a limited amount of on-site finishing. The reason for this is that in the CPF the least automated part of the process is in the finishing and packing areas. While powdering with icing sugar is relatively automated through the use of "tumblers", where doughnuts can pass through and be powdered on a belt, filling with jelly and cream takes place at filling units which are hand operated and can only deal with two doughnuts at a time. It may, therefore, be just as effective to carry out this process in back-room facilities on the retail premises, which would also allow greater flexibility.

Food usage cost is the cost of food produced on the premises, including sandwich fillers, coffee, cream, etc. This varies with the share of these items of the overall sales mix. For coffee, freshness is ensured by throwing out what's left after 18 minutes. To minimise wastage the coffee makers can be set to brew half or a third of a pot to match the pace of customer throughput. This is down to the supervisor's judgement based on on-the-job observation. Linked to food usage costs are paper costs, which include all the items needed as part of a sales to a customer, e.g. paper napkins, cups, trays for sandwich fillers, etc., and increases where coffee and sandwich sales are boosted.

## The future of the project

Further future developments of the Richmond project centre around the two key areas of the selection of new sites and the development of new stores to their full potential through the integration of the Dunkin' Donuts and Baskin-Robbins formats in the same shops and under the same management.

Dunkin' Donuts are currently developing five types of distribution point. Freestanding units are detached buildings situated next to busy roads. They have good visibility, limited seating and some drive-through facilities. End-cap units are Dunkin' Donuts shops located in a corner position on the outside of shopping centres. Cart systems are used to integrate a doughnut distribution point into a larger host environment. Wholesale and branded product locations facilitate the sale of the product through third parties. At present the CPF delivers to 11 store locations, between six and ten branded locations and six wholesale locations (typically hotels).

## Site selection

A detailed break-even analysis is carried out prior to the acquisition of a new location. In the Richmond area, Dunkin' Donuts do not own any land, but hold ground leases. The leasehold is depreciated over ten years.

However, if there is a land lease and a new building is erected, then depreciation is charged over the term of the lease. For the break-even analysis, fixed costs include rent, depreciation on the leasehold, equipment costs and renovation costs. Nationwide, Allied Domecq expect new shops to achieve break-even on their operations within two and a half years. In the context of the Richmond project, currently only type A locations are acquired. These are locations which break even from the first day of opening. In the Richmond project, site selection for the new company owned and controlled retail outlets is carried out by the corporate real estate and development manager, who decides on the site, negotiates the lease, gets planning permission and works with the construction manager to determine design issues. She also decides on the correct media mix for the advertising campaign. Company control strengthens bargaining power, this is useful in negotiating with landlords for the best sites.

Key selection criteria for new sites include:
- population density and characteristics;
- traffic flows;
- proximity of other outlets.

The population density within a half mile and a three mile radius of the proposed site is assessed. In addition, an evaluation of socio-demographic population profiles is carried out. To this purpose, Dunkin' Donuts subscribe to a number of demographic profiling services, such as Equifax and CACI. Corporate traffic flow criteria state that during the peak hours of the morning, mid-afternoon and evening, a potential site must be accessible to at least 1,200 cars. Actual traffic flows are determined in three ways. The first stage is a preliminary assessment through the use of published official counts. If this appears satisfactory, the real estate and development manager conducts her own car count outside the proposed site, using a purposive sampling approach to cover key times during each day in the course of one week. This exercise results in the gathering of qualitative as well as quantitative data. It is complemented by an analysis of the main activity generators in the area (e.g. employment, retail activity). This provides an insight into the reasons why the cars observed are there. The outcome of this stage determines whether or not to progress any further. For a potentially promising site, the third stage involves the use of a traffic consultant who carries out a week-long full count. For inner city areas, traffic flow counts may be supplemented by pedestrian flow data.

Proximity of other outlets must also be taken into account when assessing a potential site. Experience has determined that a population of 35,000-50,000 people is needed to support one Dunkin' Donuts store, and 30,000-35,000 for one Baskin-Robbins.

## Integration of Dunkin' Donuts and Baskin-Robbins

The combination of the Dunkin' Donuts' and Baskin-Robbins' offerings in the same outlet serves to make much more profitable use of the prime sites acquired. The main reason is that peak trading differs dramatically between the two. Whereas 65 per cent of Dunkin' Donuts' sales are generated between 6.00 a.m. and 11.30 a.m., Baskin-Robbins' trading peaks between 6.30 p.m. and 9.00 p.m. Because of the slight differences in the population bases required to support the two concepts, it is envisaged that the optimum mix will be 60 per cent Dunkin' Donuts to 40 per cent Baskin-Robbins. The company is currently scanning the market for potential lunchtime concepts to add to this combination. Clearly, having a retail concept capable of trading round-the-clock in this manner also further strengthens the argument against production on the premises.

The traditional Baskin-Robbins' format makes use of a CPF with no manufacturing on the premises. For Baskin-Robbins the trend is also towards greater efficiency. While in the older locations Baskin-Robbins sell around 48 varieties of ice cream, there is a tendency to open more shops, with less variety in each shop. The Baskin-Robbins' slogan incorporates 31 sorts "one for every day of the month", but in some of the cart locations only the eight most popular flavours are sold.

Richmond is the first area for which both Dunkin' Donuts and Baskin-Robbins are controlled by the same management. For the rest of the USA they are still managed as two separate brands. Because of differences in management information systems Dunkin' Donuts and Baskin-Robbins combination stores are still managed largely as two businesses under the same roof. For the Richmond project there is currently only one such "combo" operating, but most of the new stores will be combos and three of the existing outlets are remodelled as combos.

## Conclusion

Richmond is functioning as a laboratory and it will be a while before the innovations featured have any claim to being tried and tested. If the project succeeds then this opens

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up the opportunity for marketing the central production concept with retail-only satellite stores as a new franchise concept.

Currently much of the focus in Dunkin' Donuts' franchisee training and development is on the manufacturing side. Once franchisees have acquired their outlets, they lead hard lives with unsociable hours, typically starting work at 1 a.m. in the morning to prepare the doughnuts for the morning rush. The retail-only concept would give the company greater control over the product and would also be likely to attract a much wider base of potential franchisee. The training focus could be on the service and marketing side of the business, with just enough product knowledge to be able to identify the causes of problems. It is envisaged that groups of franchisees could invest in the joint ownership of CPFs. Early informal communications indicate that there is a lot of interest in such a concept from existing Baskin-Robbins' franchisees who are keen to enhance the use of their assets. However, the real corporate challenge for the future may lie in the successful identification of a suitable third concept that could add yet another peak in trading during the lunchtime spot.

## Further reading

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