

McDonald's hopes new cold drinks will be hot

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McDonald's aims to be king of beverages as well as burgers.

DETROIT — Think of [McDonald's](#) and the first thing that pops to mind is a burger — and fries.

Think again. The nation's largest fast-food chain is on a multibillion-dollar mission to become a serious beverage juggernaut, too.

In the process, it's turning the fast-food world upside down. It's trying to redefine consumer habits for the simple act of stopping for a drink. And that's pitting it against convenience stores, supermarkets and specialty coffee chains such as [Starbucks](#). The chain has slowly been rolling out iced frappés only since March, but CEO Jim Skinner already credits April's impressive 3.8% same-store sales boost, in part, to frappés. Now, smoothies are on tap. Beverages are certain to be discussed at what's expected to be a very upbeat annual meeting in Oak Brook, Ill., on Thursday. McDonald's has seen impressive growth and improved same-store sales while most rivals have struggled over the past few years.

Expanding the beverage line into pricier drinks is seen as a way to boost check averages as well as lure customers to McDonald's for snacks during slower parts of the day, such as afternoons. But the company's growing beverage platform also raises this question: Is McDonald's straying too far from its roots?

The short answer: No. In its earliest days, [Ray Kroc](#) sold milkshake machines to McDonald's before he bought the restaurant operation known for its burgers and fries.

There is still plenty of room for McDonald's to fail as a beverage kingpin — some are even certain it will — but the prize is so potentially huge that McDonald's, which has few other growth options, can no longer ignore it.

"How big is big?" poses Karen Wells, vice president of U.S. strategy & menu at McDonald's. "It's really big when you have \$153 billion out there for the taking," she says, in reference to the amount Americans spent on non-alcoholic beverages last year.

McDonald's is following the money. And consumer tastes. Specialty coffee is a \$13 billion market in the USA, says the Specialty Coffee Association. Coffee sales at McDonald's have jumped double digits every year since 2006, when it rolled out premium coffee. So why stop there? "The sky is the limit," says Wells, pointing straight upward.

Detroit is where it all starts

The unlikely proving ground for this industry changing action: Detroit. During the depths of the recession, even with double-digit unemployment, this is where McDonald's says it figured out how to turn its specialty-coffee-serving McCafés from regional concept to national player. But McDonald's is no longer satisfied with McCafés just selling hot, espresso-based coffee drinks. It has locked in plans to continue to roll out iced smoothies and frappés nationally in the next few months — and follow that with an enormous marketing campaign for both drinks in July. [Morgan Stanley](#) analyst John Glass doesn't blink when he says the new beverage mission "is the biggest thing McDonald's has done since it rolled out breakfast." That's no small matter, as breakfast, which began in 1977, now accounts for 25% of McDonald's near \$31 billion in domestic sales.

Once smoothie and frappé sales are rolling, McDonald's annual specialty beverage sales could hit \$2 billion, making it the No. 3 specialty beverage retailer in the U.S., behind only [Dunkin' Donuts](#) and Starbucks, says Glass.

McDonald's projects those incremental sales at closer to \$1.5 billion — or \$125,000 per store.

The hope is that there will be times during the day when customers might decide to stop at McDonald's when they want a drink and nothing more. "We're giving customers another reason to visit McDonald's," Wells says.

Customers such as Darnell Richard. The twentysomething car-restoration worker walked into a Detroit McDonald's one recent afternoon not for a burger or bag of fries, but for a \$2.29 smoothie. He did the same thing, he says, one recent evening at 3 a.m. — bypassing the 24-hour convenience store where he used to go to quench his late-night thirsts. "It's a buck cheaper," he says of the McDonald's smoothie. "And it tastes better."

Goal: To be a beverage destination

As cola sales fell, McDonald's executives grew frustrated watching folks pass through the drivethrough — or walk into the restaurant — bringing energy drinks, fancy coffees or smoothies purchased elsewhere to have with their meals, says

John Sicher, publisher of *Beverage Digest*. "McDonald's decided to become a beverage destination."

McDonald's figures if it can lure folks in for a specialty beverage, it can sell them something to eat

while they're there. And it also figures that if it can get folks to come in for burgers and fries, it can similarly coax consumers to bump up their checks from soft drinks to double-the-price smoothies. That's exactly what Deborah Virgiles is doing at the two McDonald's restaurants that she owns in Detroit. She hands out samples of smoothies daily to customers — even sending one employee out to the drive-through order box where he hands samples to drivers from a tray.

She's taught cashiers to tell folks ordering value meals that for another \$1.29, they can substitute a smoothie for a [Coke](#). She rewards staff with food coupons every day a store sells more than 350 smoothies and frappés. The effort is paying off. Since the drinks rolled out in March, her stores are selling about 1,400 weekly. "I want to make sure no customer walks out of here without a beverage," she says. So does Detroit franchisee Gary Granader. His McCafé is selling 1,000 extra drinks per week, "And beverages are the most profitable part of my business." Specialty beverages such as espresso coffees, smoothies and frappés are the fast-food industry's next gold mine. The company makes about \$1 profit on each smoothie sold. No wonder McDonald's is trying to give more heft to the McCafés it spent up to \$1.5 billion putting in U.S. units. The rationale is simple, says Harry Balzer, chief industry analyst at the research firm NPD Group. "The No. 1 thing ordered at a restaurant isn't food, it's a beverage," he says. What's more, adds UBS Securities analyst David Palmer, "A beverage is its highest-margin sale, even higher than french fries."

Considering the costs

But there are complications. At \$2.29 for a small smoothie or frappé and \$2.79 for a Hot Mocha, the drinks are pricey and can be labor-intensive. Some are chockfull of calories. While McCafés have spread at an astonishing clip, some franchisees have complained about slow sales. But none of this may stop McDonald's from prevailing as the nation's beverage behemoth. Its annual beverage sales in the USA already top \$6 billion.

Perhaps the most outspoken doubter of McDonald's specialty beverage dream is [Richard Adams](#), a former franchisee turned consultant. He likes the smoothies and frappés because they're iced drinks and more in line with McDonald's heritage. But he says espresso-based drinks at McCafés have been a bust. "This is the first time in the history of McDonald's that they've done something visionary — and I use that term negatively," Adams says. "They've never proven that this will work. They simply don't have the empirical data." He says the typical McCafé is only selling about 35 espresso-based drinks a day. That's not up to McDonald's standards, he says, which is more typically in hundreds of units. After four years of trial and error, he says, there's no data that prove consumers want designer coffee at McDonald's. Miriam Natividad begs to differ. The Detroit physical therapist sits in a McDonald's on a recent Monday sipping a cappuccino. "I've transferred from Starbucks to McDonald's," she says bluntly. "It's much cheaper here."

What Starbucks, 7-Eleven think

Starbucks says it isn't concerned. Last month, during an analysts call, CEO [Howard Schultz](#) insisted that Starbucks is actually benefiting from the millions of dollars McDonald's has spent promoting its McCafés. "We're feeling no (negative) effects from what McDonald's is doing or saying. It's a non-factor," he said. But McDonald's is certainly a factor within the specialty coffee industry, says Ric Rhinehart, executive director of the Specialty Coffee Association of America.

"We always expected McDonald's to enter the fray. But I'm surprised at how thoroughly and quickly they've moved in — and at their commitment of scale. "McCafés are in 12,000 of the nation's 14,000

McDonald's. And almost every one of them currently has very visible window signage promoting the McCafés.

McCafé also has the full attention of the convenience-store industry. More than 25% of sales at 7-Eleven stores are non-alcoholic beverages.

"Any time McDonald's starts playing in a new segment, it hits our radar screen," says Alan Beach, vice president of merchandising at 7-Eleven.

Perhaps that's why 7-Eleven is modernizing its beverage service and replacing the unsightly rows of glass coffee pots with metal urns. And, yes, it's testing smoothies and shakes.

It also is watching the McDonald's stores in about 25% of the country that are testing sales of bottled Vitaminwater and PowerAde. Back in Detroit, Sara McParland, a 20-year-old

McDonald's crew trainer, shows a reporter how quickly she can make a smoothie. She squirts in some flavoring, stirs in the icy mixture and pushes a button that sends the cold, steel blades whirring.

"That's 30 seconds," she crows, as she pours the drink, then passes it to a drive-through window attendant who hands it to a thirsty driver. The young driver speeds off sipping her smoothie, with no idea that she may be holding the future of McDonald's in her hand.