February 23 2009

WSJ: Pizza Chains Were Already Struggling; Then the Economic Downturn Hit

Times are tough in the U.S. pizza business.

Once synonymous with a cheap meal, pizza's popularity among America's fast-food consumers is waning. On the one hand, its reputation as a bargain has been eroded by pricey ingredients -- some in the industry refer to cheese as "white gold" -- and aggressive competition, especially from chains peddling cheap hamburgers. On the other hand, it is getting squeezed by changing tastes, as some consumers bypass pizza for fresher, more upscale dining options.

Exacerbating the situation is the most precipitous economic downturn in decades, which has sparked a dramatic pullback in consumer spending.

Conditions late last year were "the worst I'd seen" since entering the business 32 years ago, says John Schnatter, founder and interim chief executive officer of the Papa John's International, which is based in Louisville, Ky.

The industry's troubles are creating problems for franchisees of the three biggest chains: Papa John's, Domino's Inc. and industry leader Pizza Hut, a unit of fast-food giant Yum Brands Inc.

While hamburger chain McDonald's Corp. has posted consistent gains in its domestic same-store sales, with 4% growth in 2008, U.S. franchised same-store sales at Domino's fell 1.7% in 2007 and 5.6% in the first nine months of 2008. Papa John's is predicting its same-store sales will be flat to down 2% this year, and Pizza Hut, whose same-store sales slipped 1% in the fourth quarter of 2008, is off to a slower start than expected this year, according to Yum, which has called the division its biggest challenge.

Pizza's woes started before the current recession gripped the nation. Figures compiled by Chicago-based restaurant-consulting firm Technomic Inc. show that while the overall U.S. fast-food category experienced compounded annual growth of 6.4% from 2002 to 2007, pizza sales rose only 2.5% during that period.

"The pizza segment's struggles are part of a longer-term secular trend in which market share is being lost to healthier and fresher dining options on one side and less expensive burger and sandwich players on the other," says Walter Butkus, principal at Restaurant Research LLC, a Redding, Conn., consulting firm.

Indeed, as the big pizza chains struggle, smaller chains and independents have enjoyed growth, industry observers and analysts say. Among the selling points for these smaller operators are gourmet pizza with ingredients such as caramelized onions, as well as beer and wine and take-and-bake pizzas. Also denting the big pizza chains: The advent of inexpensive, casual restaurants offering perks like sit-down service, Wi-Fi Internet access and multiple television screens.

Things worsened last year when the price of cheese, which represents about 40% of a pizza pie's cost, soared to record levels before settling somewhat. Despite a history of competing on price -- some 85% of pizza-chain sales are tied to promotions and discounts, according to Citigroup Global Markets -- some pizzeria operators concluded they could no longer afford to use value pitches to woo customers.

The result: McDonald's and other hamburger purveyors stole market share by attracting hordes of penny-pinching consumers daily with value meals, some with entrees priced at $1 or less.

To reclaim customers, Pizza Hut and Domino's are broadening their menus -- Pizza Hut with pasta and Domino's with oven-baked sandwiches. And, in an apparent attempt to jump aboard the healthful bandwagon, Pizza Hut recently said that henceforth its pies will be made only from natural ingredients.

But venturing outside of one's traditional fare can be risky. In selling toasted subs, for example, Domino's is taking on large chains such as Subway and Quiznos, which already are slugging it out in a price war. In addition, successful product launches require significant spending on advertising, which can distract attention from a firm's core business, says Mr. Butkus of Restaurant Research.

But David Brandon, chief executive of Domino's, Ann Arbor, Mich., believes the company needs to take action. "The burger guys have their 99-cent offerings," he said at a recent investors' conference in New York.

"We feel like we have to be in that space and in that game" by offering lower-priced alternatives like the hot sandwiches, Mr. Brandon said.

Papa John's, meanwhile, is extending sweeping financial assistance to its franchisees. The company is delaying for at least six months an increase in its royalty rate on sales to 4.5% from 4%. It also is rolling back the royalty it collects on Internet-generated sales, a fast-growing part of its business, to 2% from 3%, and markedly cutting the price of cheese it sells to franchisees. Finally, those franchisees suffering the most will get special marketing support.

"This is not a program for the slough-offs," says Mr. Schnatter, who initiated the effort after concluding that if Papa John's did nothing it might have to close some 200 stores this year. Although Papa John's isn't booting out franchisees for sales disappointments, the chief executive says they are expected to work hard to meet quality, service and cleanliness standards and show they deserve the company's help.

Ray Sears, a Papa John's franchisee who calls 2008 "the toughest year we had," says reducing royalty rates on online sales could save him thousands of dollars because those orders account for 22% of his total. He and his partners own nine Papa John's stores in the Annapolis, Md.-Washington, D.C. area.

Still, Papa John's isn't predicting a quick rebound for the company. It says it anticipates closing more U.S. stores than it opens this year because of the financial challenges faced by many of its franchisees.

Domino's, meanwhile, has pointed to poor-performing franchisees as one of the sources of its trouble.

In explaining the company's sales slump to investors, Mr. Brandon has said that some franchisees ramped up pricing too much when commodities prices soared last year, and the consequences were serious. "In many cases, we chased off that value-oriented buyer," he said at a recent investor conference.

As of the third quarter of 2008, 47 of the 247 franchisees the company felt weren't operating up to its standards had left the system and another 89 were planning to sell their stores and exit this year. The remaining 111 are working to improve their restaurants and remain, the company says.

The company's better-performing franchisees who are in a position to grow by buying or building new stores are getting help in the form of a short-term royalty reduction, Domino's spokesman Tim McIntyre says in an email. The incentive has been offered periodically over the years and was reinstituted in 2008, he says, without quantifying it.

"Virtually every commodity that touches our business -- cheese, wheat, meats, tomatoes, corrugated cardboard, energy -- were at their highest levels" last year, Mr. McIntyre says in describing the cost pressures facing the industry. Still, he says, "we continue to believe that franchising in the pizza industry is a solid endeavor -- one that can be lucrative for the right kind of entrepreneurial individual."

Wall Street is circumspect. In initiating coverage of Domino's in December, Citigroup was dubious about a near-term recovery, forecasting "below-average top-line trends" through 2010. The company's shares are down more than 50% since early last year.

A survey taken by the Domino's Franchisee Association last summer indicated widespread dissatisfaction among its members over the return on their investments.

Morgan Stanley restaurant analyst John Glass, alluding to such feelings, recently told clients, "We're not convinced that the fallout from the strained franchisee system has yet to hit bottom. We would expect more store closures in 2009."

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