Case study

Product strategy in harsh economic times: Subway

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Abstract

Purpose – This paper aims to describe a pricing process that can aid companies in modifying their product strategy.

Design/methodology/approach – The case describes an approach that uses grass roots data from franchisees to change pricing strategy effectively.

Findings – The paper illustrates the wisdom of franchisees with customer contact and an intimate knowledge of customer wants. The application may not be applicable to all industries. The restaurant industry is affected by numerous economic conditions that can bankrupt operators. Fast food operations usually lose less business than traditional restaurants, since consumers who want to eat out but need to economize "trade down." Within the fast food sector, Subway capitalized on consumers' need to economize and reduced the price of its sandwiches. It was the right move for the times and Subway enjoy considerable success. Their results can be valuable to other companies.

Research limitations/implications – As in all case studies, the specific conditions found in one organization may not be found more generally in others. Readers are cautioned that the conclusions drawn in this case may have limited applicability.

Practical implications – The case depicts the process that one firm used to boost sales and compete effectively by matching customer wants to the characteristics of the product offering.

Originality/value – The case describes how a pricing strategy, focusing on the needs of a target audience, can boost sales amid an economic downturn.

Keywords Product management, Pricing policy, Recession, Consumer behaviour

Paper type Case study

Periodically, the *Journal of Product & Brand Management* features cases, which focus on a single company or industry to showcase current best practices that can benefit practitioners or advance theory. This case focuses on the best practices that have emerged during the worldwide economic slowdown and how one company capitalized on its partners' insight.

Today marketers are faced with the infrequent but not unprecedented challenge of a staggering economy. In the west, product developers and brand managers have spent years building the image of their wares and creating preference in their audiences. The best have managed to differentiate their brands so well that within their target audiences, they have created mini-monopolies. Some have succeeded so well that their brands are preferred globally. It is sometimes difficult to remember that the foundation of this success is a functioning economic system.

The pre-recession triumphs

Retailers like Nordstrom's and Bloomingdale's, car manufacturers like Mercedes-Benz and Lexus have succeeded very well in satisfying high end wants at a profit. They've worked hard at building customer relationships and loyalty based on a high level of product and service quality. As long as the economy was healthy, product managers could build and enhance customer relations and brand equity.

The economic downturn and its effects

In 2009, the world seems turned upside down. Economic issues have plagued a variety of industries. One example, the financial meltdown in the US, reduced the availability of credit that fuels the homebuilding and auto industries, and severely reduced sales. Many industries have suffered but one, the restaurant industry, seems to be the poster child for the economic malaise. When viewed through the perspective of an industry analytic tool like Porter's 5 Forces framework (1980), the industry has several vulnerabilities. Several of Porter's forces exert their effects on the restaurant industry. Perhaps the most obvious is the threat of substitutes and its three components:

1 Switching costs.
2 Buyer inclination to substitute.
3 Price-performance trade-off of substitutes.

Economists state that the threat of substitutes exists when a product's demand is affected by price changes of substitute products. Porter's model describes substitute products as products in other industries. As more substitutes become available, demand becomes more elastic since customers have more alternatives. Restaurant meals have numerous

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substitutes outside the restaurant industry. They range from home cooked meals to supermarket salad bars to gourmet frozen meals aimed at busy two income households. All of them are less expensive; have low to non-existent switching costs and attractive price-performance trade-offs. The industry performance results have been predictable. Recent industry figures show that the $566 Billion US restaurant business suffered a 3.6 percent decline in customer traffic in summer 2009 versus the previous one. More important, fast food chains, which usually benefit from customers' "trading down" to save money, suffered a 3 percent decline in traffic this summer. That was their worst performance in years.

In 2008, Booz & Company studied consumer habits and uncovered some emerging trends that are pertinent. The survey noted the unprecedented confluence of three major economic factors:

1 a dramatic rise in oil prices;
2 a significant erosion of housing values; and
3 a worldwide credit crunch.

They form the perfect storm that is shifting consumer behavior. Accordingly, Booz & Company surveyed nearly 1,000 US households to gain insight into the effects of the current economic environment on their consumption. The survey covered actual changes in consumer behavior.

Logically, lower income groups have made deeper cuts by aggressively cutting back on spending. However, all economic groups have shifted consumption. The survey revealed that consumers' first reaction involved three areas of cost-cutting:

1 staying at home more;
2 shopping frugally; and
3 driving less.

The cuts are not easy since many subjects report valuing these activities highly. Consumers report that they have focused more on things they can do "at home," such as entertaining friends ($\sim$27 percent). Other home-based activities include watching more TV ($\sim$27 percent) or spending more time on the internet ($\sim$25 percent).

The results show that the vast majority of consumers have already made substantial cuts in their spending. Moreover, they expect to make deeper cuts in the near future. Table I details some of the money saving actions that customers in the survey have adopted. Most have a direct effect on restaurant sales and support the empirical results reported above. The activities directly related to restaurant meals involve an average of 35 percent of consumers. While the qualitative nature of the actions does not allow precise prediction of the effects, it is clear that the expense of meals is of concern.

The results shown in Table II, detail what consumers have done or planned to do in the next six months. The data is more alarming that that in Table I. In 2008 consumers were preparing for an extended period of frugal spending, signaling dire consequences for restaurants. A total of 62.2 percent of consumers in the sample plan to eat less outside of the home within six months. Overall, the picture for restaurants for the next year is far from rosy.

Developing competitive strategy

Even in devastating times, it is possible for a brand with the right product mix to excel. It takes intelligence, good management and a bit of luck. Nowadays, value, expressed as a level of quality for an affordable price, seems to have traction.

One notable response to customers' needs to economize can be found with the Subway sandwich shop chain. The company which competes behind giant McDonald's has surpassed veteran Burger King and Wendy's in market share. Subway achieved its success on the back of a bargain basement franchise model and a product line that featured what the company calls America's favorite fast food, the sandwich. The total investment for a McDonald's franchise ranges from $950,200-$1,800,000, plus a royalty fee of 12.5 percent or more in 2009. In contrast, a Subway franchise involves a total investment of from $78,600-$238,300 plus a royalty fee of 8 percent. Part of Subway's success is its affordability to franchisees which allows it faster diffusion of distribution.

As a whole, the industry has embraced value meals; cutting prices and offering more for less. It is a reaction to more consumers who are avoiding restaurants in an effort to save money. For the industry, price-cutting is a tested technique to weather an economic downturn. However, midrange and upscale restaurants are in a difficult position. Traditional restaurants serving $15 dollar entries might be able to slash

Table I Ten of the top 20 changes consumers have made

	Percentage of respondents making significant change
Eat outside the home less	43.2
Eat at less expensive restaurants	39.3
Eat at fast food restaurants less frequently	35.4
Pack lunch for work	34.8
Eat more leftovers	32.4
Order less food when you go out to eat	29.7
Reduce number of vacations	28.1
Entertain friends at home instead of going out	27.0
Use coupons	32.1
Drive less overall	36.5

Source: Leinwand et al. (2008)

Table II Ten of the top 20 changes consumers have made or plan to make in the next six months

	Percentage of respondents making significant change
Eat outside the home less	62.2
Eat at less expensive restaurants	58.3
Eat at fast food restaurants less frequently	53.3
Pack lunch for work	47.7
Eat more leftovers	41.0
Order less food when you go out to eat	48.1
Reduce number of vacations	46.7
Entertain friends at home instead of going out	44.3
Use coupons	41.4
Drive less overall	43.6

Source: Leinwand et al. (2008)

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the price to $12, but the cost is still significant to consumers who eat at home inexpensively. In the fast-food arena, McDonald's was one of the first to recognize the consumer's need to economize. It introduced a successful line of value meals that captured the market's imagination and became the front runner that others emulated. Other chains whose major products were hamburgers followed suit along with those whose focus was chicken or tacos.

Value meals have really had an impact on fast food outlets, which have seen an increase in traffic. While traffic is up, profits are down. The lure to customers is low price and those $1 meals are priced at 2002 levels; a level insufficient to generate profits confidently.

An example of shifting competitive strategy

In this environment Subway blazed its own trail with its own product line. The chains, in their advertising, might argue over which product, the hamburger, chicken, the taco, or the sub sandwich is America's favorite fast food meal. Subway contends that it is the sandwich. Its product line consists of numerous varieties of sandwiches served with different fillings and on different types of bread. The choices are complex but the product line is anchored by one choice: 6 inches or 1 foot long.

A few years ago, Subway focused its advertising on its healthy but tasty offerings. It featured a testimonial by a satisfied customer, Jared Fogle, who stated that he lost 245 pounds by substituting one 6″ Subway sandwich a day for one of his meals. The results were impressive and the company embraced the Jared testimonial of the health benefits of eating its food compared to others. The campaign proved to have excellent timing as activists continued to criticize the fat and calorie content of competitor's offerings. Subway introduced tortilla wrapped offerings labeled Carb Conscious Wraps with reduced carbohydrate content as well as sandwiches and salads with 6 grams of fat or less. One web site (http://caloriecount.about.com/) lists fast food items by company and provides a grade book rating them from A to F. Most of Subway's items are graded A to B to C with a few items like Golden Broccoli Cheese soup earning a D+ for its fat content. In contrast, McDonald's has a few A's notably salads (without dressing) and a good amount of B's and C's while most of its tasty items flunk with D's and F's. Items like its Big Breakfast and Bacon, Egg and Cheese Biscuit earn F's.

After the company realized the value of Jared's testimonial, it applied its professional communications staff to create appealing advertising, harness social media, and develop online relationship building activities. For example, the corporate web site includes one major link, among the five links on the homepage – 20 percent of the space is devoted to Jared and his journey to a healthy body. Intelligently, the web site designers and message engineers use the tag line, "Jared's Journey – because losing 245 lbs and staying healthy is never over." The message echoes the advice of nutritionists and may keep customers engaged over the long haul.

The company created a virtual center for weight loss on its web site. It includes major sections couched in user friendly terms. They are "How he did it," "How you can do it," "Video and pictures," and even a game. The results feature Jared's history, his progress toward a stable lower weight and testimonials from other people over the United States who heard about Jared's success and emulated him. It employs the tested techniques that weight loss professionals use with their clients. Overall, the site is impressive and a customer relationship analysis would reveal its effectiveness.

Clearly, Subway has a strategic advantage with the nutritional quality of its food and the link with Jared's weight loss success proved to be effective. Still, advertising needs to be refreshed to remain effective and unique selling propositions need to remain relevant. The Jared campaign focused on a unique selling proposition that lost some of its relevance as the economy declined.

Responding to the environment

Store owners and corporate analysts across the industry were aware of the pinch consumers felt and the negative effect on sales. Franchise operations are sometimes governed by shared decision making and getting all franchisees to pursue a particular action can require consideration and voting. The result is a measure of inertia or stability. In stable environments, the resulting uniformity among franchisees can be valuable. In turbulent times, it can hamstring attempts to adapt.

The development of corporate strategy

Franchise operations enjoy several benefits including the breadth of knowledge of the franchisees, their financial strength, and their abilities to spot opportunities. Subway enjoys all three. Franchisees are the interface between the customer and the company. They operate within their local communities and know what is going on better than most executives at "corporate." They may know their customers and the pressures they experience. Franchisees are in a good position to react to meet their customers' needs. One obstacle to their flexibility is that most franchisees have limited amounts of freedom to experiment. They usually cannot develop new products, or advertising. However, they may have some ability to modify standard pricing. That freedom led to an important discovery. In Florida, one enterprising franchisee, Stuart Frankel, saw slow business and losses on the weekend and determined to reverse the trend. He was aware of the state of the local economy and customers' decisions to economize. In response, he decided to change the value proposition. Instead of sandwiches ranging in price to $7, he offered the Subway foot long sub at a discounted $5 price on the weekends. Remarkably, he saw an immediate increase in weekend traffic that was a bit overwhelming. The calculus was favorable. Despite the reduction in revenue per sandwich, he found increased customer traffic that sometimes resulted in long lines at lunchtime. Instead of having idle employees on the weekend, he actually had to add employees to handle the volume. Accordingly, both ingredient and labor costs increased dramatically. Frankel found that the increase in store traffic and boost in employee productivity was more than enough to offset the increased costs, even at the discounted price. It was a logical step to extend the offer beyond Saturday and Sunday. Soon, $5 per foot long was the price throughout the week.

Other local franchisees were at first skeptical. They are professionals who know their business model completely and know that price cuts are often damaging. Still, they saw Frankel's success and within their powers to change price, cautiously followed the weekend discount strategy. Their

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success caught the attention of the corporate staff that presented the results at a national franchisee's meeting and asked for a vote to institute the discount policy company wide. The vote would have been non-binding, yet the results were negative. Frankel was unaffected. He and local franchisees continued the $5 foot long pricing strategy. During that time, franchisees across the country also took their own tentative steps toward the $5 deal. Without corporate support their promotional efforts were limited to local advertising and amateurish signs taped to store windows. Those franchisees, who discounted, saw immediate positive results. Word of the success reached more franchise owners and at the next corporate meeting, the resolution to start discounting passed – for a four week trial period. The remarkable thing was that this grass roots empirical data violated Subway's carefully designed marketing strategy which is based on extensive marketing research. The data was so compelling that Subway broke its own rules.

At this point, Subway corporate brought its promotional and logistical clout to bear. Managers wanted an advertising campaign that would feature the $5 deal but would stand out from the clutter and be memorable. The communication concept was simple: $5 – foot long. Some of the Italian-American executives joked that they should put an Italian spin on it. They referred to the tendency of Italians to use hand gestures to punctuate their speech. Consequently, someone came up with two hand signs: five fingers (signifying the price) and two hands spaced a foot apart (the length of the sandwich). Those two gestures, combined with a jingle meant to be "annoying" would get attention and communicates the deal clearly, even to distracted TV viewers. It has become cliché to say that something succeeded beyond expectations. However, Subway did succeed beyond its expectations. The annoying jingle and hand gestures were not only noticed, they became the stuff of parody. Word of mouth spread like an epidemic. Sales increased and U-tube hosted over 3,000 videos of people performing their own versions of the commercial. The environment helped get people's attention. The economic news continued to worsen as weakened Wall Street icons failed or were taken over by rivals and gave the discount a new meaning and imperative.

As the promotion succeeded, Subway's logistical chain came into play. Shortages of ingredients from bread to sandwich fillings became commonplace and corporate had to pressure suppliers to ramp up production to meet the need. In some cases, new suppliers were needed. As more outlets benefited from increased sales, market share and profit, corporate extended the promotional period from four to seven weeks. Competitors quickly sensed the market opportunity that Subway demonstrated and developed their own discount offers. Each of them developed a price based special hovering around the $5 mark, what today seems to be a naturally attractive price point.

With competition sapping some of the $5 foot long demand, and mindful of the cost of some of the more expensive sandwiches, Subway limited the $5 items to eight with the least expensive ingredients. Some franchisees have reduced the offering hours from all week to limited hours on weekends or traditional low volume days. Individual franchisees have the discretion to keep or change the promotion. Indeed, some in economically depressed South Florida have discounted the discount and offer $4 foot long subs and continue to operate profitably.

The discount strategy proved to have traction with today's customers. It has to be applied responsibly and monitored to insure its viability. Then too, as competitors react to an organization's strategy, changes – sometime wholesale changes – may be required. Despite the caution, the discount offer alone represents a $4 billion success.

Currently, there are fears that the $5 deal will lose its appeal. As always, corporate strategists try to prepare for changes in the environment. So far, no one is considering an exit strategy. Subway seems committed to riding the crest of this success until it peters out.

Summary

Subway represents a unique example of a company being flexible enough to change its operating policies. Moreover, as a franchising organization, it had the wisdom to listen to its partner franchisees. In any competitive strategic change data for forecasting is valuable. In Subway's case, its franchisees supplied that data and demonstrated the price discount's effectiveness.

It also illustrates the importance of internal persuasion. In most cases, strategies have to be embraced and owned by all the stakeholders to be successful. In a franchise organization, getting all the players to cooperate requires preparation.

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