Subway

You can never have too many stores

FRED DELUCA HAD EARNED HIS FIRST MILLION DOLLARS BY the time he was twenty-five. Today the Florida-based billionaire earns an estimated $1 million a week courtesy of the Subway fast-food business he cofounded when he was just seventeen years old. DeLuca's current earnings are a far cry from the $1.25 an hour he used to earn in the local hardware store, a wage that inspired him to earn some real money to pay for his degree in medicine from the local university in Bridgeport, Connecticut.

A family friend, scientist Peter Buck, put up $1,000 seed capital to fund the sandwich shop. (Today Buck, who sits on the board of parent company Doctor's Associates, earns similar amounts to DeLuca.) The plan was hatched at a family get-together, and the pair spent time looking at the successful delis in the area, deciding on a limited range of sandwiches served in foot-long or six-inch rolls. Family and friends helped set up the first store, calling it Pete's Super Submarines. The doors opened in Bridgeport in 1965, with the first day's trading excellent despite the fact that DeLuca only had one knife in the store.

The Subway business is now the second biggest fast-food chain in the world behind McDonald's, with a new store opening somewhere in the world every four hours. There are more Subway stores in the U.S. than McDonald's, but the chain is a long way behind the golden arches internationally. There are now more than 24,000 Subway stores in eighty-two countries around the world as opposed to McDonald's 30,000 outlets in one-hundred countries. Subway had annual sales in 2003 of $5.7 billion, McDonald's had sales in 2003 on $17.1 billion.

After the initial rush at the first Pete's Super Submarines, the weather turned wintry, and subsequent advertising and promotional campaigns failed to boost sales. "Nobody came into the first store," says DeLuca. DeLuca's instinct was to open more stores, working on the theory that more stores would increase recognition and help build the brand. Buck agreed to the plan. Subway's close-knit group of suppliers extended their credit to the business and DeLuca used the cash to open further stores. The second store opened in 1966. By 1968 there were five sandwich stores, now called Subway, and the business was looking healthier. DeLuca and Buck then set a goal of thirty stores.

In 1972, DeLuca was knocked-back from a bank for a loan and given the advice that he would never find any institutional support until he had a proper business plan and financial statements prepared by an accountant. The business was still not making any real money (although DeLuca had made his first million). DeLuca discovered that by being savvier about controlling costs, there could be bigger profits. He became a self-confessed penny-pincher, obsessively controlling costs, monitoring stock, supplies, and every facet of the business to minimize waste.

Franchising did not start until 1974 when DeLuca persuaded a friend to become a franchisee. DeLuca even paid the $14,000 fee as a sweetener. If he didn't like the sandwich business he could walk away and not owe a thing. DeLuca devised a franchise model that did not need much retail space, equipment, or elaborate fit-outs. Subway would receive a franchise fee and a royalty fee. (The royalty fee is currently 8 percent. In the early days the amount was much smaller.)

The business took off. In 1984, the first store opened offshore in Bahrain. By 1990, there were 5,000 Subways around the world. Subway's plans for growth were succeeding beyond DeLuca's and Buck's expectations. Every time they set a goal, they reached it way ahead of schedule.

The franchise model was far from perfect. For starters, there is always the risk that a franchised store will not work. An average of

1 percent of new Subway stores fail to thrive. Then, because of opening franchised stores in Japan, the business had an initial burst of sales but then failed to prosper. (The theory in Japan is that Subway rolls are too big for Japanese women to eat in public, it being considered gross to eat a giant mouthful of tuna sub.) Disgruntled franchisees sued Subway after pumping their life savings into the failed stores.

DeLuca also complicated the lives of franchisees by letting new Subway franchisees open stores wherever they liked, even if it was in the next block from an existing Subway store. DeLuca stuck with his belief that the more stores there are, regardless of whether some stores cannibalize another's sales, overall sales will be up. And the more stores, the more royalties for DeLuca. DeLuca now has a committee to handle problems, although franchisees must pay a fee to have their case heard.

DeLuca is the first to admit his company has made some mistakes with franchisee relationships, particularly over the territorial rules. Despite the controversy, and lawsuits in Japan, Canada, and the U.S. against Subway. There are still franchisees lining up to own a Subway store and 70 percent of new openings are by existing franchisees—just as DeLuca thought he needed several Subway stores to make a decent living, his recruits are thinking along the same lines.

DeLuca talks to his franchisees every month through "Fred's Home Video," the company has regular email updates, and new franchisees can attend Subway's sandwich school.

Subway has a very decentralized business model. DeLuca is chairman of Subway's parent company, Doctor's Associates. Then there is a separate company to handle Subway's administration, another to handle property leases, and another layer of independent agents acting as consultants to Subway's existing and potential franchises. These agents receive half of the initial franchise fee, one-third of royalties paid by franchises, and a transfer fee if stores are sold. They screen for new franchisees, scout for retail locations, and also manage teams of inspectors who anonymously visit Subway stores to ensure owners are sticking to Subway's guidelines.

Subway franchisees also pay 3.5 percent of their turnover to fund Subway's advertising budget. The company's advertising agency has a board made up of people elected by Subway franchisees to represent their interests. DeLuca himself cannot overrule the direction of this board. "At least half the time I would have done things differently," he says. "But this does not mean that I would have been doing things any better."

DeLuca has a secret weapon against other fast food rivals—a Houston, Texas, college student named Jared Fogle who used to weigh 425 pounds. Fogle noticed a local 1998 Subway advertising campaign promoting its sandwiches with less than six grams of fat. He started eating a low-fat Subway sandwich for lunch and dinner. A year later, he had lost 245 pounds. Fogle's mother wrote to Subway to thank them for his transformation. Subway did not respond to the letter. But the company did call after they noticed sales jumping in areas where newspapers had run stories on Fogle.

A campaign was launched around Jared Fogle that is arguably the most successful fast-food campaign ever. Fogle became a household name. Subway's pitch as the healthy alternative boosted sales by 33 percent, perfectly timed to cash in on a growing anti-fast food sentiment and the fears surrounding Mad Cow Disease. By 2001, Subway was selling close to 1 billion sandwiches annually. Fogle quit his day job with an airline and became a full-time Subway spokesperson. "And yes Fogle has been compensated very, very well," says DeLuca.

Despite his wealth, DeLuca has no plans to leave Subway. In the 1990s, he tried to launch other franchise ideas: budget hairdressers, spicy fried chicken, and a hamburger chain called Q burgers. They all flopped. He insists that Subway will not go public either. Since the late 1990s, DeLuca has been linked to the consortium Schaghticoke Tribal Nation, which planned to operate a casino in Kent, West Connecticut. The $12 million speculative investment has not paid off and has descended into a complicated, expensive legal battle. DeLuca lives in Orlando, Florida, with his wife and family. In 1996, he set up the Micro Investment Lending Enterprise (MILE), a non-profit seed funding organization to help entrepreneurs who do not have access to traditional loans. "We were never very sophisticated as business people," says DeLuca. And look where $1,000 took him.

NOTES

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Mrs. Fields Cookies

"It's the lack of perfection that drives me crazy"

DEBBI FIELDS WAS JUST TWENTY WHEN SHE HAD HER BIG idea. Recently married and living in Palo Alto, California, she decided she was not cut out to be a housewife for the rest of her life. She had no business qualifications, but she had baked cookies at home since her early teens and figured it was her