McDonald’s

Did somebody say a loss?
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Despite announcing a loss and a new strategy, McDonald’s is still trying to act like the growth stock it once was, rather than the cash cow it is today

“THE world has changed. Our customers have changed. We have to change, too.” Brave words from Jim Cantalupo, chairman and chief executive of McDonald’s for the previous 100 days, who promised investors at a Wall Street meeting on April 7th that the world’s biggest fast-food chain no longer wanted to be bigger than everybody else, just better.

It is a promise the company will struggle to keep. In January McDonald’s announced its first quarterly loss since going public in 1965. Comparable store sales in America, stagnant for the past decade, have been falling for 12 months. McDonald’s, once a byword for good service, has been ranked the worst company for customer satisfaction in America for nearly a decade—below even health insurers and banks. The group’s share price has slumped from more than $48 in 1999, to hover around a ten-year low of $12.

Mr Cantalupo, a 28-year McDonald’s veteran who was yanked from retirement in January to replace Jack Greenberg, the abruptly replaced previous boss, insists he can reverse all this in 12-18 months. At long last he is doing something about the fact that McDonald’s has massively misallocated capital for decades. The group is slashing its capital spending this year by a third, to $1.2 billion. Net of closings, it will open 360 restaurants worldwide in 2003, compared with more than 1,000 last year and 1,700 a year in the 1990s. The firm is under threat of yet another rating downgrade. Yet, as well as repaying some debt, some of the money saved will be returned to shareholders, though the firm frustrated investors by refusing to say how much.

Even more damning, Mr Cantalupo and Charlie Bell, his number two and heir-apparent, spent much of their presentation promising improvements in the basics of restaurant management—cleanliness, service and staff productivity—just to keep customers coming back. Under Mr Greenberg, McDonald’s did not even have a system for monitoring standards, so as to avoid trouble with franchisees. A grading system and “mystery shopper” policy are now in place, and the group promises to get tougher on its owner-operators.

The menu too has been a mess. It will be slimmed, so to speak. There will be fewer confusing meal choices and more healthier, premium products such as salads, yoghurts and sliced fruit. Although it has long denied that its food is linked to obesity, McDonald’s, a firm that is all about image, has finally twigged that its brand is under threat from its unhealthy reputation. In a confusing attempt to be all things to all people (something Mr Cantalupo said he wants to avoid) the group plans to offer “champagne taste on a beer budget”, with new premium-priced foods, even as it declares value “part of the brand heritage”. Advertising and store ambience are getting an overhaul too; the group’s classier French stores may be a model. Less classy is Mr Bell’s idea to aim Ronald McDonald, the group mascot (and apparently the second most-recognised icon in America after Santa Claus) at young adults, a “key demographic” after children.

All this leaves many investors wondering whether McDonald’s really “gets it”, as Mr Cantalupo kept insisting in his presentation. With the rise of “fast casual” restaurants such as gourmet sandwich shops, the McDonald’s offering looks increasingly outdated. The group’s most recent genuine menu hit was the introduction of Chicken McNuggets in 1983. Franchisees, used to 10-15% annual growth and fat margins, have seen their profits come under pressure and have been alienated by poorly executed initiatives from headquarters, such as the expensive new “Made for You” kitchens that they had to buy.

What difference at McDonald’s?

Yet top management in Oak Brooks, Illinois, including Mats Lederhausen, the strategy director, and Michael Roberts, head of American operations, as well as Messrs Bell and Cantalupo, are all long-time insiders, shaped by the previous, out-of-date strategy. Mr Cantalupo, who masterminded the group’s international expansion in the 1980s and 1990s “lacks the vision or stomach to make the necessary changes”, commented one analyst.
The top team’s wooden presentation on April 7th, liberally doused with marketing clichés and soundbites about the importance of “people, product, place, price, promotion” and “improving focus”, only reinforced that impression. Above all, it is clear that Mr Cantalupo and his team still see McDonald’s as a growth company, albeit one with more modest annual targets of a 3-5% increase in sales and a 6-7% rise in operating profits from 2005. The implication is that, after implementing the revitalisation plan, capital spending will be cranked up again and the aggressive restaurant-opening programme will resume.

They appear unwilling to acknowledge that McDonald’s, rather like Coca-Cola or Disney, is these days a mature company in a much more competitive market that should be run for cash. That is certainly what many shareholders want. Bryan Knepper, of Columbia Management Group (FleetBoston’s renamed asset-management arm), says he wants recompense for the underperforming share price: “I want them to give cash back to shareholders.” Another investor suggests that, with a yield of only 1.6%, McDonald’s should double its 24-cent dividend, which costs it a mere $300m a year. A third muses that “my dream is that they pay a huge dividend and expand only with the incremental operating profit of existing stores. They need to earn the right to grow again.”

Ironically, Ray Kroc, who founded and then expanded McDonald's as much by buying and renting property as by selling hamburgers, has left the group a gold mine to exploit. Peter Oakes, an analyst at Merrill Lynch, notes that the group owns 75% of the buildings and 40% of the land at its 30,000 locations. He calculates that the land alone, which has a book value of $4 billion, would fetch $12 billion (before tax) today. That value could be exploited through a sale-and-leaseback programme.

McDonald's also admits to thinking about selling a controlling stake in its portfolio of “partner brands”, which includes such chains as Boston Market chicken, Chipotle burritos and Pret a Manger sandwiches. This portfolio is worth around $1 billion. The group could have been more draconian in cutting capital spending, as it needs only $600m-700m a year for maintenance. It could also, albeit more riskily, have slashed its marketing budget.

Add it all up and McDonald’s could easily hand several billion dollars back to its investors. Given the looming danger of obesity litigation and a backlash against marketing “unhealthy” food to children, returning supersized lumps of money to shareholders now could come to look farsighted. Alas, it may take more change at the top to milk this particular cash cow.