Taking Stock: McDonald's loss won't be your gain

by Malcolm_Berko

Dear Mr. Berko: In March of 2003 I asked for advice on McDonald's. It was $32 then and you told me not to buy. My broker said you were nuts and on his recommendation I did buy 300 shares and now have a 27-point profit. I saw that the company took a loss last quarter and the stock dropped dead in its tracks. Why did MCD have a loss last quarter? Do you think this is a buying opportunity and that I should buy another 300 shares?

L.C.

Syracuse, N.Y.

Dear L.C.: Your broker was right as Sunday and I was certifiably nuts telling you not to buy McDonald's Corp. (MCD-$59.38) in early 2003. Way back then, a MCD man at the Oak Brook, Ill., home office told me, "We are so big that it's impossible for us to introduce new products, better strategies and expect reasonably complete compliance." Well this fellow certainly made a mistake in judgment and your 27-point profit is pure proof of my goof, too.

MCD posted its second loss ever of $711 million (60 cents a share) for the June quarter vs. a profit for the like quarter a year ago of $834 million, or 67 cents a share. This recent loss has nothing to do with operating efficiencies, revenues or corporate irregularities. MCD's only other loss was caused by a slump in revenues in the latter half of 2002, and I believed that slump was a sign to dump the stock.

The reason for this quarter's loss was management's sound decision to exit its business in the Caribbean and Latin America. Few of those 1,609 units were profitable. They were a cash drain, a time drain and a management drain and the unique characteristics of their demographics made those units nearly impossible to manage effectively. Removing those 1,609 units from its corporate portfolio was a good move. While the consequences resulted in a one-time charge of $1.31 a share, this significantly reduces MCD's exposure to an inhospitable business climate. MCD will receive $700 million in cash for ceding control, which it will use to repurchase company stock.

Excluding that one-time charge, MCD's second-quarter revenues grew to $870 million and net profit increased from 67 cents to 71 cents a share. Management seems to be doing a yeoman's job. Global sales grew by 5 percent aided by a delivery service in 40 foreign cities where traffic patterns are in constant gridlock. MCD's even delivers in Manhattan so customers living in nearby high-rises and office buildings phone in their orders. Of course, there's a 50 cent to $1 courier fee that covers the costs of handling phoned-in orders, drivers and motorbikes.

In the last few years, management has been doing an excellent job of running the company and in the next few years I believe the stock price may better reflect management's successes. Since 2002, net profit margins have increased from 11 percent to 14.3 percent, shareholder's equity and return on capital grew by 60 percent, the dividend improved fourfold to $1 and may even be raised to $1.20 this year as expected earnings reach a record $2.70 a share on $23 billion in revenues. Meanwhile, growth in Japan and China should continue its impressive surge, growing by almost 10 percent.

MCD expects to strengthen its leadership in the fast-food market and its efforts to revitalize the MCD brand is working well in the U.S. and generating strong numbers in Europe and Asia. Management decided, in 2003, to concentrate on increasing revenues from existing units rather than focus on building new units to capture new revenues. And it's been working. Management has introduced new menu items such as premium coffee, salads, chicken, Mexican wraps, smoothies, iced coffee, "cinnamelts" and other food items to match local demand.

MCD is almost more American than apple pie, Cracker Jacks and nighttime baseball. MCD employs more (486,000) people than Campbell Soup, General Mills, Heinz, Dow Chemical, DuPont, Hershey, General Dynamics and Lockheed-Martin combined ... and easily more than General Motors, Ford, Honda and Toyota. The long term looks attractive for MCD with revenues, earnings and dividends expected to come in at $27 billion, $3.70 and $1.75 respectively by 2011. I like this company and I believe management is doing an exceptional job.

But I can't find a compelling reason to buy more shares of MCD because I believe the stock is fairly priced for the next few years. I told you this over four years and 27 points ago but I was wrong as Corrigan. However, I believe my advice is closer to the button this time than it was in 2003.

Please address your financial questions to Malcolm Berko, P.O. Box 1416, Boca Raton, FL 33429 or e-mail him at malber@comcast.net.

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