FINANCIAL TIMES

Where's the beef? McDonald's uncertain recovery.

23rd May 2015

Terry Smith

Fewer people are going to the fast-food chain and the decline is accelerating.

Where's the beef? is a catchphrase in the US. It originated as an advertising slogan for the fast-food chain Wendy's in a TV commercial in 1984. Since then it has become an all-purpose phrase questioning the substance of an idea, event or product. It strikes me as relevant to the current predicament of McDonald's.

McDonald's, the world's largest fast food operator, is experiencing serious problems. Global same store sales have now been down for four consecutive quarters and six of the past nine quarters.

US same-store sales have now been down for six consecutive quarters. European same-store sales have been down for four consecutive quarters and for seven out of the past 10 quarters, and you shouldn't ask about what is happening to McDonald's Japanese sales if you are squeamish.

Perhaps even worse is the fact that the number of customers visiting McDonald's in the US fell 1.6 per cent in 2013 and then 4.1 per cent in 2014. The European guest count fell 1.5 per cent in 2013 and then 2.2 per cent in 2014.

Nor are things any better in the developing world. Same-store sales in Asia-Pacific, the Middle East and Africa have been down for eight of the last 10 quarters and the guest count fell 3.8 per cent in 2013 and 4.7 per cent in 2014.

In other words, fewer people are going to McDonald's and the rate of decline is accelerating.

Some commentators would have you believe that the problem rests with the entire sector, for which they use the pejorative term "junk food". Yet Domino's Pizza reported results for its first quarter ended March 2015 with US same-store sales up by 14.5 per cent, and this is not an isolated example.

Nor can McDonald's blame the economy: the company managed 3.8 per cent same-store growth in 2009 and 6.9 per cent in 2008. Comparable global sales grew in every month in 2008 and 2009.

The fact is, there is something fundamentally wrong with McDonald's rather than the whole fast food sector. It affects all regions of its operation and it is getting worse.

At least McDonald's has figured out that it has a problem. The result is a new chief executive, Steve Easterbrook, who ran the relatively successful UK operations, and the obligatory "turnround plan" launched at an investor conference.

My misgivings about this plan began with the news release which preceded the conference. It said the new chief executive identified the company's priorities as threefold: "driving operational growth, returning excitement to our brand and unlocking financial value". It continued, "the first critical step of our operational growth-led plan is to strengthen our effectiveness and efficiency and drive faster and more customer-led decisions". I'm not sure I know what this means, but what will he do to achieve it?

Restructure the business, of course, into four new segments. As well as the US, the business will have three other segments — "international lead markets", "high growth markets" and "foundational markets". How rearranging the reporting segmentation will help is beyond me — a phrase about the rearrangement of the deck chairs on the Titanic springs to mind.

Note that the word "food" was entirely absent from the release and the word "burger" was only mentioned once, as in "burger company".

Language which felt like it had been lifted from a management consultancy lexicon continued in the chief executive's presentation: "As we turn around our critical markets, we will create strategies which leverage our scale and competing power, bring disruptions to life and sharp brands on the move. We will also seek to be more progressive around our social purpose in order to deepen our relationships with communities on the issues that matter to them." Note, still no mention of the food.

I think that the first thing McDonald's needs to address is whether its target customers like the food it sells, and if not, figure out why this is and what it can do about it. Domino's Pizza did this in 2009 when it made a very public mea culpa about the quality of its pizzas, publishing some damning findings from a customer survey along the lines of "the cardboard box tastes better than the pizzas". This is the sort of action you only take if you intend to change and Domino's has been reaping the benefits since.

But I don't think we should solely blame McDonald's management for this lack of focus on the one thing that matters more than any other — the food. The analytical and investment community must share the blame. To illustrate why, here are the first three questions from analysts in the Q&A session following the chief executive's presentation:

1. The first questioner asked whether the increase in the percentage of franchised restaurants, which McDonald's is planning, would be dilutive or accretive to earnings per share ("EPS").

2. The second questioner suggested that the higher franchised percentage should enable the company to support a higher level of debt.

3. The third question was on whether the company had considered an Opco-propco structure in which a company's properties are held in a "PropCo" and leased to the Operating Company or "OpCo" with the PropCo then usually sold to "unlock the value" in the company's real estate.

In other words, all these analysts seemed to be interested in was financial engineering. They do not seem to realise that without a business selling something which customers want, no amount of financial wizardry will create lasting value. But faced with this obsession with financial legerdemain among the analysts, you can hardly blame the management for sharing some of the same focus.

If you are thinking of investing in McDonald's or any other potential "turnround" situation I suggest you hold back until you encounter a CEO who talks about the need to improve the company's product or service in a basic manner. Someone who can answer the question, "Where's the beef?"

Terry Smith is chief executive of Fundsmith LLP