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MCD a Compelling Buy on Irrational Selling

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McDonald's (MCD) is getting clocked today.

This is not because of EPS or revenue growth, both of which were stellar. This is not because of disappointing growth in Europe or Asia, where the company is doing great. It is not due to margins, which rose despite rising commodity prices.

It is due to flat margins in the United States for the month of December. With January nearly in the book, the company stated that January comps in the U.S. will rebound to a range of 1% to 2%.

The U.S. is about to get a slug of monetary and fiscal policy. Since the beginning of the year, crude prices are down about 10%. The weather for most of the country has been spectacular in January. Thus, most of the headwinds that McDonald's could have faced will be turning to tailwinds as we enter the end of the first quarter and the beginning of the second quarter.

Add to that:

- China growth;
- the European adoption of new products and menu expansions that were so successful in the U.S.;
- the successful introduction of the McCafe concept in Germany -- I understand that Canada has some as well in Montreal (is there anyone up north who can confirm that for me?) -- which could be expanded to the U.S. (imagine a McCafe across the street from the every **Starbucks** (SBUX) in the U.S.); and
- a hefty 3% dividend and stock buyback.

When you put all that together, McDonald's is a compelling buy on today's irrational selling. If you echoed my actions when I took some McDonald's off the table in December, then it might interest you to know that I have repurchased some McDonald's today.

McDonald's reported fourth-quarter 2007 EPS of 73 cents, excluding one-time net tax benefits of 33 cents, on revenue of $5.75 billion. Currency translation benefitted earnings by 4 cents in the quarter. Same-store sales in the U.S. rose 3.3% in the quarter but were flat in December. Asia-Pacific, Middle East and Africa same-store comps were 11.4% in the quarter, while Europe also delivered double-digit comp increases.

McDonald's Board of Directors has decided that, beginning in 2008, the company will pay its dividend on a quarterly rather than on an annual basis. The first quarterly dividend will be for 37.5 cents, payable on March 17, 2008, to shareholders of record on March 3, 2008. This quarterly dividend is in line with the annual rate of $1.50 set in November of 2007. Expect the dividend rate to get a boost sometime this year.

By my calculations, operating margins improved by 319 basis points, from 20.35% to 23.54% for the quarter. Per McDonald's margins at company-operated restaurants rose 70 basis points, to 17.2%, with the improvement coming in Europe and Asia-Pacifc offset by small declines in the U.S. Franchise margins increased 80 basis points, to 81.5%, and 78% of restaurants are now franchised vs. 74% a year ago.

The company expects the economy to negatively impact results in the U.S. by 1% to 2%.

January 2008 same-store comps are expected to be 1.5% after adverse weather conditions caused a flat comp in December.

European same-store sales are expected to rise 8% to 9% in January. Europe will continue to build on momentum of executing the company's plan of brand reimaging and expansion of drive-thru services. Earlier hours have boosted breakfast sales by 22% in the U.K. New menu promotions offering chicken and premium burgers in the U.K. will continue. No slowdown is seen in the U.K. A full 100% of German restaurants will be reimaged by the end of 2009. For the McCafe upscale coffee and pastry concept, 100 new units will be added in Germany this year, bringing the total count to 500.

Comps of 6% to 7% are expected in Asia-Pacific, Middle East and Africa in January, with Japan, Australia and China driving the strong results. Over half of Chinese restaurants now offer 24-hour service.

In 2008, McDonald's will invest $2 billion in capex. This will be balanced between new restaurant openings and reinvestment in existing units. An estimated 1,000 net new units will be opened in 2008, which is in the 1% to 2% growth target that the company has described in the past. McDonald's remains committed to returning $15 billion to $17 billion to shareholders from 2007 through 2009.

The U.S. commodity price outlook anticipates chicken prices to rise 4% to 5%, cheese to rise 8% to 9% and beef to be flat. This commodity inflation is similar to that of 2007, and McDonald's believes that the pressures will be manageable.

MCD Preview: How Are Domestic Sales Doing?

McDonald's (MCD) is scheduled to report fourth-quarter and full-year 2007 results before the market opens on Jan. 28 and follow up with its quarterly conference call at midday.

The company is expected to earn 71 cents per share on revenue of $5.61 billion for the quarter and $2.87 per share on revenue of $22.99 billion for the full year. In the year-ago quarter, McDonald's earned 61 cents per share on revenue of $5.63 billion.

While McDonald's normally provided monthly sales data in the first or second week of the month, it appears that, for December, the company will report that data with the full quarter's results. For October, McDonald's reported systemwide sales increases of 14.2% and constant currency sales growth of 8.2%. November proved to be an even stronger month as total sales rose 16.2% and 9.6% on a constant currency basis.

Global same-restaurant comp sales rose 6.9% in October and 8.2% in November. Comps were strong and positive across all geographic regions, including the U.S. This has helped to put a wedge between McDonald's and its domestic quick-service competitors, which are all struggling at home.

As for December, there is no reason to believe that McDonald's will slow down. The company should report positive sales growth and positive comps. The real test will be at its U.S. restaurants where rising gas prices and slowing economic conditions could be a factor.

Before you jump to any conclusions, however, consider that these factors could drive stronger sales as McDonald's benefits from the substitution effect and continues to take coffee market share away from the struggling **Starbucks** (SBUX) .

When McDonald's was at $62.50 just a few weeks ago in December, I alerted *RealMoney* readers to take some McDonald's off the table while keeping a core position for the future. Since then, McDonald's shares have pulled back 20% at the point of last Monday's lows after rebounding by 4 points over the course of the hectic market week.

If McDonald's can meet or beat estimates, then I would consider next year's estimates of $3.18 to $3.20 to be realistic, which would maintain my one-year price target of $62.50 to $64.

A final bit of caution is worth noting. While I do not expect commodity costs be a significant risk factor for McDonald's in the year ahead, should the U.S. dollar show any strength in 2008, that could impact total sales and EPS growth estimates for 2008.

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At the time of publication, Rothbort was long McDonald's, although positions can change at any time.

Scott Rothbort has over 20 years of experience in the financial services industry. In 2002, Rothbort founded LakeView Asset Management, LLC, a registered investment advisor based in Millburn, N.J., which offers customized individually managed separate accounts, including proprietary long/short strategies to its high net worth clientele.

Immediately prior to that, Rothbort worked at Merrill Lynch for 10 years, where he was instrumental in building the global equity derivative business and managed the global equity swap business from its inception. Rothbort previously held international assignments in Tokyo, Hong Kong and London while working for Morgan Stanley and County NatWest Securities.

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