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**MCD Sells Off on Commodity Cost Fears**

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7/23/2008 3:27 PM EDT

For Rothbort's preview heading into the McDonald's conference call, please click [here](#).

McDonald's (MCD) is executing superbly in a difficult economic and commodity cost environment. The company is taking market share from a variety of competitors -- such as **Starbucks** (SBUX) for coffee, not to mention the casual dining chains.

Furthermore, growth in China will continue and the company is focused on Russia now more than ever. The Beijing Olympics will be a big boost for McDonald's in third quarter 2008 and beyond.

Clearly, commodity costs are going to be an issue in the second half of the year. It is precisely those fears that have traders selling off the shares after the great quarter that was just reported. For me, McDonald's remains a core long-term position, and there was nothing that I heard today that would change my opinion.

Earlier today, the company reported second-quarter 2008 EPS of \$1.04 on revenue of \$6.075 billion. EPS rose 44% year over year after adjusting for the Latin American franchise sales.

Global same-store sales increased 6.1% year over year for the quarter. By geographic location, same-store sales were as follows:

- U.S. up 3.4%;
- Europe up 7.4%; and
- Asia/Pacific up 8.8%.

U.S. operations:

- Seventy-five percent of comps were driven by increased traffic.
- The dollar menu is 14% of sales.
- With commodity cost pressures in place, McDonald's is testing other options.
- Breakfast, chicken and beverages (hot and iced coffee) are driving sales strength.
- Coffee is now offered in 12,800 U.S. restaurants, with specialty coffee in more than 1,600 restaurants.
- Through 2009, the company will add smoothies, frappes, bottled beverages and energy drinks to the menu.

European operations:

- More than 70% of restaurants now offer extended hours helping to drive comps.
- All German restaurants will be reimaged by the end of 2009.

- The U.K. will reimagine 3,000 restaurants in 2008 and 2009, with an emphasis on drive-thru concepts.
- With a population of 143 million people, Russia is the high-potential growth market in Europe, and McDonald's has only 195 units.

Asia/Pacific/Middle East operations:

- Operating income increased 22% in constant currency.
- Margins rose.
- China and Australia remain strong.
- In Japan, sales and guest counts rose as McDonald's is taking market share in a flat capacity market.
- The company added new items to the 100-yen menu in Japan.
- Seventy-five percent of all restaurants in China are now open 24 hours.
- McDonald's added four units to serve the Olympic athletes, media and spectators.

A great deal of the call and Q&A was centered on commodity costs. Here are some items that were discussed:

- No single commodity makes up more than 15% of the company's food bill, with beef being the highest at 15%.
- U.S. operating margins declined 40 basis points year over year due to commodity costs.
- Food costs rose 2% in the U.S., with chicken up 6%; for the full-year, chicken is expected to rise 5% to 6%, and beef is expected to increase 8% to 9% in the U.S.
- In Europe, commodity and labor costs rose 6%, with chicken rising 8%; for 2008, chicken is expected to rise 7% to 8%, and beef will tack on 8% to 9% in Europe.
- There is a lot of volatility in the beef market. Recently, Russia banned import of Latin American beef.
- Beef prices will be higher in the second half; with the first half being in the 2% to 4% range, the company is looking at 8% to 9% going forward.
- In a normal commodity market, McDonald's needed 2% to 3% comps to maintain margins.
- McDonald's has become vertically integrated with its suppliers from farm to final processing. ([See my Finance Professor articles on the food chain.](#))
- Sales of value meals have not grown significantly, but the cost implications have, and hence the company is doing some testing. The dollar menu will look different in the next year.
- Price increases to customers are in the 4% range year-to-date.

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At the time of publication, Rothbort was long MCD, 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

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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.

Rothbort holds an MBA in finance and international business from the Stern School of Business of New York University and a BS in economics and accounting from the Wharton School of Business of the University of Pennsylvania. He is a Term Professor of Finance and the Chief Market Strategist for the Stillman School of Business of Seton Hall University.

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