June, 2014

What Ails McDonald's? How Can It Be Fixed?
A Three-Part Analysis

This inaugural issue of IAP's *Commentary and Insight* collects three columns recently published by Milo Jones, one of our Managing Directors, on the investment website *Seeking Alpha*. They addressed the strategic problems facing one of the nation's most respected QSR chains, McDonalds (MCD).

While aimed at MCD investors, these pieces summarize IAP's views on several of the trends and challenges facing QSR restaurants today: increasing menu complexity versus clarity of offering; changing perceptions of food integrity; and the delicate balance between franchisees and franchisors. Naturally, some of the discussion is unique to McDonald's, but we believe that some of these dilemmas are worth considering by other restaurant firms and restaurant investors.

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McDonald's And Menu Simplification: Part 1 Of 3 Ways To Tell When The Worst Is Over

Apr. 16, 2014

Summary

- MCD's share price and earnings have underperformed relative to the S&P and restaurant peers over the last 12 months.
- A large part of MCD's problems in the USA stem from an overcomplicated menu.
- Despite management's recognition of the problem, empirical observation indicates that they have not adequately addressed the issue.
- Store visits are one way to keep abreast of MCD's progress fixing this problem.

The Value of Hands-On Research

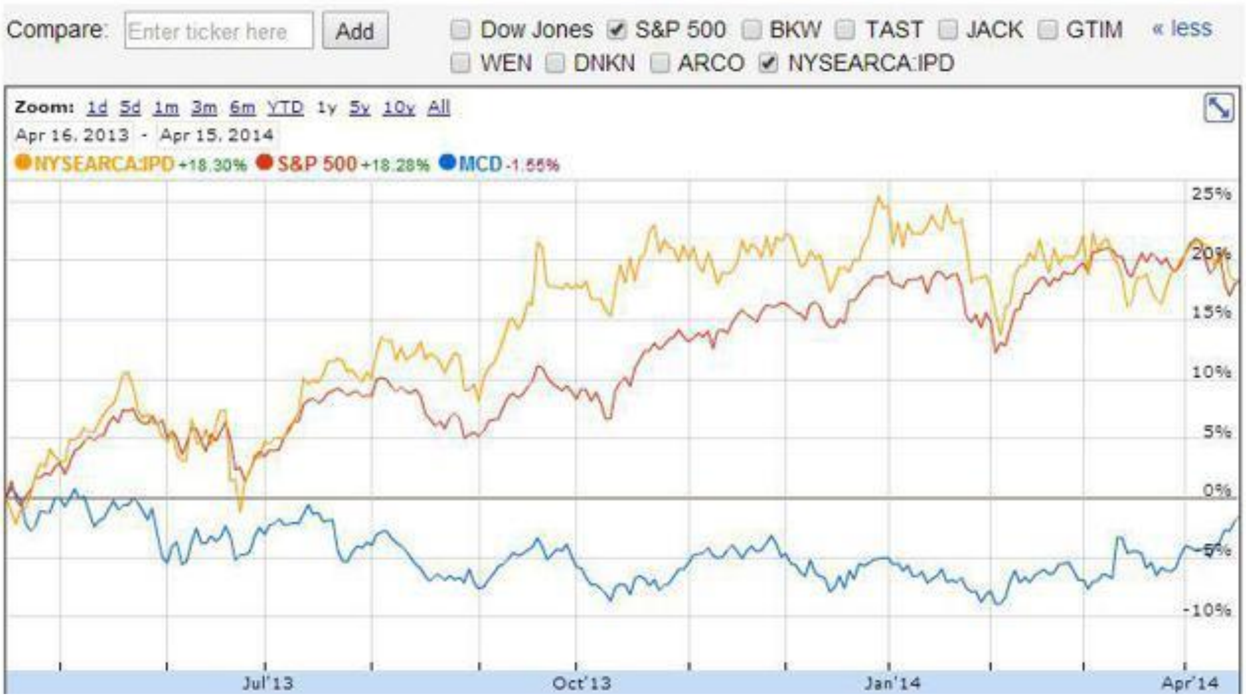
Investors are often right to be skeptical of the idea that their personal experience with a company is a reliable guide to its overall performance or share price. As statisticians like to remind us, "The plural of anecdote is not evidence".

Yet in the case of restaurant companies, a little bit of Peter-Lynch-style One Up on Wall Street empiricism still goes a long way. This is particularly the case with companies like McDonald's (MCD), where consistent execution and clarity of concept are a key part of the overall value story. Moreover, in the case of MCD, a sample is within 10 minutes' drive for most people Americans.

In this and two future pieces, I'll offer investors three ways to test for themselves the promises of McDonald's management to restore McDonald's competitiveness, and thus help them gain some inkling as to when the worst may be over for shareholders of MCD.

No investor Happy Meal here!

In the last year, MCD has performed miserably. The S&P 500 as a whole delivered just over 18% in the last 12 months; a basket of international consumer discretionary spending companies comparable to MCD - for example the S&P International Consumer Discretionary ETF (IPD) - brought in about the same. McDonald's? It's down almost 2% over the same period. If you're feeling generous (and ignoring taxes), throw in the 3.3% current dividend, and you'll get the "return" on MCD to about zero.



IPD and the S&P500, trailing 12 months; source: Google Finance 4/15/2014

So how can an investor know if and when this icon of American eating is turning things around? Well, sitting in front of your computer can tell you a lot about McDonald's. You can learn, for example, that last month it changed its executive structure, with COO Tim Fenton leaving and not being replaced, while the roles of CFO Pete Bensen and Global Chief Brand Officer Steve Easterbrook are expanding. Relatively new CEO Don Thompson has also created the role of chief digital officer and brought in Atif Rafiq, with experience at Amazon and Yahoo, to fill it. Soon enough (around the Annual Meeting on 19 May), you'll have the 2013 annual report.

Run Some (Menu) Numbers

Yet I would suggest that whatever digital, printed or audio material you find online about McDonald's, if you want to know when the worst is over, there is value in trusting your senses and visiting a few stores. As noted, I'll be addressing two other items to watch for signs of at MCD in future pieces, but let's start simply. At minimum, with a store visit or two you'll be able to detect whether McDonald's is delivering on its promise to simplify its menu.

In January, the soon-to-depart Tim Fenton told analysts, "We stumbled last year with too many products too fast and created complexity…We overcomplicated the restaurants." Fenton promised fewer products, but better execution. So far, this promise hasn't been seen in stores. Visit one: McDonald's in the US currently offers 15 types of hamburgers, 14 varieties of wraps, 13 styles of chicken sandwich, six different salads, Filet-O-Fish, McRib, and Chicken McNuggets,. That's 53 main items for lunch and dinner, to which one can add the complexity of 17 different desserts, apples slices, and specialty items like Fruit N' Yogurt Parfait. Throw in fries, and that's a lot of complexity! And then there's breakfast, with 15 sandwiches, six other offerings, hash browns, and a breakfast burrito. Meanwhile, McCafes are offering 19 variants of coffees, shakes and smoothies.

After expanding its menu by 70 percent since 2007, the number of MCD menu items peaked at about 145 items last year. But a nationwide menu of 115 main menu items for the chain is still crazy. It directly harms operations, and makes one core promise of fast food - speed - disappear. The company does not reveal sales by individual item, but it also seems hard to believe that this complexity has led to an incremental gain in sales.

Actions Speak Louder than Words

Meanwhile, McDonald's actions are speaking louder than its words, and unfortunately they're revealing the company remains committed to a more complicated menu than that which served them well in the past. In January, for example, while they announced that they were cutting menu items and slowing the pace of new product introductions, MCD leadership said that they are revamping its kitchens and adding expanded prep tables to give workers more space to assemble food. In other words, McDonald's is making space for more (likely more costly) labor.

As noted, there are many parts to the McDonald's story, and menu complexity is only one. But it is one that is easy to check. So why not can rise from your computer right now, and go see if the menu at your local McDonald's seems "simple" to you (or to the staff that serves you).

In future pieces, I'll reveal the two other things that you'll want to see fall in to place for MCD comps to return to the glory days of The Golden Arches.

McDonald's And Food Integrity: Part 2 Of 3 Ways To Tell When The Worst Is Over

Apr. 29, 2014

Summary

- McDonald's share price and earnings have underperformed relative to the S&P and restaurant peers over the last 12 months.
- Rebuilding perceptions of food integrity - how McDonald's ingredients are grown, processed and delivered - is a key long-term challenge for the firm.
- The public's growing affinity for foods perceived as marginally more "natural", "simple" and "healthy" is not a fad, it is a deep and enduring trend.
- Meanwhile, McDonald's current non-market messages address only "sustainability" and Animal Welfare: they fail to meet the food integrity challenge head on.
- If McDonald's doesn't address the issue of food integrity in a direct, coherent, and sustained manner with some "big-bang initiatives", it risks becoming the next Altria.

Keep it (Relatively) Clean

The food business is uniquely challenging. It transcends mere economics: it is a world of rapid technological innovation combined with products brimming with emotion. This emotion is ultimately traceable to the fact that in this business, "consumer" is not a metaphor. People put food in their bodies and in their families every day. Business doesn't get much more personal than that without a PG-13 rating (at least).

Right now, that unique intersection of economics, technology and deep consumer emotion lies at the heart of McDonald's (MCD) strategic dilemma. How can MCD do what they historically have done well, and also meet the increasingly contradictory demands of US consumers? Put another way, how healthy and "natural" does the titan of fast food need to become, and how fast do they need to do it?

When MCD headquarters in Oak Brook, Illinois squarely addresses these questions, investors will have their second clue that the worst is over. (The first clue as to when the worst will be over is here). Until then, expect MCD to underperform relative to its past history.

The Great American Public's Paradoxical Demands

Not for the first time, American consumers want it all: they want food with "integrity" - i.e. food that's as natural, healthy and as simple as possible. They also want that same food delivered cheaply, quickly and conveniently. Above all, that food had better be delicious (and none of the above should be understood as permission to mess with any Classics). In short, their food demands are, if not outright contradictory, then often at cross purposes.

Kraft (KRFT) has responded to this trend not only by lowering average sodium levels in many of their products, but also by agreeing in late 2013 to remove artificial dyes from three macaroni and cheese varieties. General Mills (GIS) recently reacted to similar public concern about "natural" foods by pledging to remove genetically modified ingredients from original Cheerios. In short, food concerns once confined to California communes are now the conventional wisdom of America's soccer moms, and big food companies are acting.

The "science" behind the KRFT and GIS decisions is debatable (to say the least. I'm not in love with chemistry-set style ingredients list, but there is plenty of room for healthy debate about the science here), but they reflect the rising tide of public expectation about food integrity that MCD is facing. By food integrity, I mean public concerns about how ingredients are grown, processed and delivered.

Unfortunately, no matter what the facts or science, what Exxon (XOM) is to "Big Oil", McDonald's is to Fast Food: a magnet for critics. Are Subway's meats higher quality than McDonald's? I'm told by experts that they're not. But that's not what Middle America thinks (especially when hard bodies like The Biggest Loser's Jillian Michaels endorse Subway!). Similarly, a halo of food integrity is an important factor sustaining Chipotle's (CMG) eye-popping P/E of 48.

So for investors, the key question is: how out of sync is MCD's basic value proposition with Middle America? How big a food integrity trust gap do they need to bridge, and how will they do it? As a potential investor, that question should give you pause. As a current investor, you must look for how - or even if - MCD is responding.

Distinguish Qualifiers from True Order Winners

What's an investor to do? Well, as a first step you can check the MCD website. There, in the "Values" section, you see that MCD is meeting two of the public's concerns about food integrity head on: the McDonald's site talks directly about "Sustainability" and Animal Welfare.

I hate to break it to the boys and girls in Oak Brook, but those two issues aren't order-winners for American consumers any more, they're simply qualifiers. The American Middle Class drank long and deeply from the well of the Environmental Movement. It expects basic sustainability as a feature of Capitalism 2.0, and it now finds it at businesses it loves like Wal-Mart (WMT), and industries it loves to hate, like Big Oil. Similarly, an "Ask me no questions, and I'll tell you no lies" attitude about Animal Welfare prevailed until a few years ago. Not any more: now all it takes is a couple of YouTube videos of suffering animals for a company to attract boycotts. Sustainability and Animal Welfare score MCD no extra points on the food integrity scoreboard. They are necessary but not sufficient qualfiers for MCD to remain around for any length of time.

Meanwhile, companies like Starbucks (SBUX) are busy raising the bar on sustainability and related "ethical" issues, making them a living part of the brand. Concerned (i.e. guilty) coffee consumers are happy to pay a premium to "do their part" to save the earth. (If one were being cynical, one might say that psychologically this premium is little different from the "indulgences" that medieval Christians could buy to make up for their sins. Meanwhile, the real effect of individual consumer's participation in such programs is approximately the same as that of football fans cheering for their team while watching the game on TV: it makes them feel good, but doesn't really affect the game's outcome.) We don't see McCafes responding in kind to SBUX's initiatives in this realm, do we?

In sum, the tide of basic expectations about food is rising, and it presents a strategic dilemma for those businesses like MCD that rose to greatness under a different set of expectations.

Going to the (rotten) core of the matter?

The last thing that I would allege is that McDonald's is unaware of food integrity trends. Indeed, it is partly this quest for perceived health, nature and simplicity that explains the menu over-expansion that I explored in Part One of this series. It's what put salads on the McDonald's menu as early as 2005, and partly lies behind the explosion of (perceived healthy and more natural) wraps.

But at the same time, MCD still has a problem. There is now a mini-industry of people (bloggers, journalists and food activists) who make it their business to compare and contrast how McDonalds' products age versus products without preservatives. The more popular of this bunch blog under names like "FoodBabe.com" and "The Best of Mother Earth". The not-so-subtle message of the resulting photos and opinions that they post is that food that doesn't rot (which McDonald's products appear not to) can't be good for you in the long run.

Frequently, the charges against MCD and its Fast Food contemporaries amount to little more than restatements of the Naturalist Fallacy (i.e. the simple-minded assertion that a thing is good because it is "natural", or bad because it is "unnatural"). But the damage for Fast Food firms is real. Finally, brands are about trust, and the steady drip, drip, drip of "their food has no integrity" activism is undermining America's trust in MCD's core value proposition.

"Everything needs to change, so everything can stay the same"

Therefore, investors need to look for what I call a "Leopard moment". No, I'm not talking about waiting for MCD to launch Endangered-Species Burgers. I'm referring to the famous Italian novel The Leopard, which chronicles the changes in Sicilian life and society during the 19th century. In the book a prince is compelled to choose between upholding aristocratic values and breaking traditions in order to maintain his family's influence. In the course of this choice, the prince utters the memorably paradoxical statement, "Everything needs to change, so everything can stay the same".

For investors in MCD, the paradox is the same: on the issue of food integrity, everything needs to change, so everything can stay the same, i.e. MCD continues to be a sound investment. They need to get out in front of more than issues of sustainability and animal rights, and squarely address America's demand for delicious Fast Food that's as natural, healthy and as simple as possible. Strategy is choice, and MCD can't duck the issue of food integrity forever.

Will we see the same old Big Macs, or Big Bang changes?

American consumers aren't going to drop traditional Fast Food - including McDonald's current offerings - tomorrow. (They're still smoking in substantial numbers, too, and Altria (MO) pays a sweet dividend as a result). But in the long run, investors in McDonald's need to see the firm address the issue of food integrity head on. To counter the drip, drip, drip of consumer charges about food integrity, MCD needs to announce some "big bang" changes to their positions on healthfulness, preservatives, additives, etc. These changes need to address many aspects of how MCD food is grown, processed and delivered. In other words, it isn't about fixing one thing, it is about a myriad of related and linked changes linked to perceptions of food integrity.

If MCD doesn't make some big bang changes to the Big Mac and its brothers to restore a perception of food integrity, its share price will likely continue to languish. Perhaps it will keep paying a good dividend. But with a core value proposition increasingly out of touch with Middle America, its glory days as an investment will be over. Activists will continue to bash MCD's core products, and trust in their brand will die death by a thousand cuts.

I don't underestimate the operational and logistical challenges that food integrity issues pose for MCD, but as an investor, I won't believe the worst is over until I see a decisive response. In other words, we need to see a Leopard moment, when the Oak Brook headquarters says, "Everything needs to change, so everything can stay the same".

In the final part of this series I'll address the third thing MCD investors should watch for to know the worst is over.

McDonald's And Franchisees: 3 Ways To Tell When The Worst Is Over, Part 3

June 9, 2014

Summary:

- MCD's share price and earnings have underperformed relative to the S&P and restaurant peers over the last 12 months.
- A large part of MCD's problems in the USA stem from growing tensions between corporate headquarters and MCD franchisees.
- Strategically, MCD's franchisee problems link to both menu complexity (part 1 of this series), and food integrity issues (part 2 of this series).
- Until MCD sorts out its problems with its franchisees, its share price will underperform peers and up-and-coming rivals.

While McDonald's (MCD) share price has somewhat improved since I began this series in mid-April, relative to its peers MCD continues to languish. As of this week, it was up about 6% for the year, while the S&P was up triple that (18%). The same goes for an ETF tracking the QSR sector worldwide, the S&P International Consumer Discretionary ETF (IPD), which was also up some 18% for the year.

Source: Google Finance 6/5/2014

This underperformance is no surprise: last quarter, McDonald's same restaurant sales in America decreased by 1.7 percent, and worldwide revenues increased by only 1 percent. Meanwhile, its operating income declined 1 percent from a year ago.

This article is the final installment in a series to help investors figure out when the worst will be over for McDonald's shareholders.

When (and How) will McDonald's Shares Rebound?

In the first part of this series, I linked McDonald's underperformance to menu complexity - too many items on the average restaurant's menu board.

In the second part, I also connected MCD's declining fortunes to consumers' ebbing faith in the integrity of McDonald's food: how the MCD's ingredients are grown, processed and delivered is out-of-sync with the public's affinity for food perceived as marginally more "natural", "simple" and "healthy".

In this final part, I connect these two ideas to the final factor that explains MCD's underperformance: McDonald's deteriorating relationship with its owner-operators, the franchisees who make the magic happen (or not) every day. This relationship has historically been at the center of MCD's success. Until investors see evidence that this core relationship is improving, expect the price to languish. Essentially, right now the solution to declining sales suggested by McDonald's Oak Brook executives (increased menu complexity and discounts), is not compelling to franchisees and is counterproductive operationally. Performance at the US store level is lagging.

Meanwhile, MCD headquarters is basically ducking the long term brand cancer that a declining perception of MCD's food integrity represents, and antagonizing owners by expanding the menu (among other things). Conversely, the franchisees will be more energized when headquarters provides a compelling vision on where they're taking the brand (back to Middle America, but the one of today) and then work to get it supported by franchisees.

If the franchisee relationship remains a mess (and apparently it is), expect sub-optimal MCD share performance in the medium to long term.

Who Controls What?

Before we go any further, a rough sketch of the relationship between MCD's headquarters and its nominally independent franchisees is in order. After all, some 80% of MCD restaurants worldwide are owned and operated by franchisees. In the US, with some 14,100 locations, that figure is closer to 90%.

So who controls what? As the grantor of a franchise, Oak Brook literally writes the rule book, or operating agreement, for MCD franchisees. Essentially, this means that they call the shots concerning:

- **The Menu** that each restaurant must offer
- **The Brand** - Oak Brook sets the national and local advertising agenda; it proposes campaigns, and then franchisee cooperatives spend the funds to execute the advertising and market plan
- **The Real Estate** - McDonald's manages all the site evaluation, acquires the property, and constructs the building; they then charge rent (right now, in the franchisees' view, too much!)
- **The Quality Standards** for both food and service (both suffering)
- **The Training** - for which franchisees pay a fee, and which takes employee time
- **The Supply Chain** - there are franchisee buying cooperatives, but overall MCD is in charge
- **New Product and Equipment Standards** - MCD sets these, though it is the franchisee who is required to make the investment to meet these standards

What do the Franchisees control? Some lines are fuzzy, but basically McDonald's restaurant owner-operator controls:

- **The Prices** of most menu items (but with important exceptions like the "Dollar Menu" - currently a sore point)
- **The Labor** - owners hire, set wages and schedule shifts; obviously, they have to balance Oak Brook standards of both service and cleanliness with both local conditions and their desire to make a return
- **The Purchasing and Maintenance of Equipment** - again, these decisions are driven by Oak Brook standards, but the franchisee has some say about timing and type
- **The Purchasing of Supplies** - franchisees purchase their supplies independently, but through buying cooperatives from approved suppliers
- **The Local Advertising** - each restaurant is required to spend a minimum of 4% of gross sales annually for advertising and promoting the business; they also vote on regional and national ad campaigns
- In the future, **Health Care** - Under Obamacare, after 2015 franchisees will have to pay for employee health care if they have more than 50 employees

How the Money (and Tension) Flows

The final piece of the MCD/franchisee puzzle is how the money flows. Not surprisingly, this is where the tension is building.

Generally, MCD requires a minimum investment of $750,000 of "non-borrowed personal resources" to grant a franchise. After that initial investment, franchisees pay MCD anywhere from a low 8% to as much as 12% of store sales in rent to Oak Brook. In addition, all owner-operators pay headquarters a 4% service fee (for things like training and software), plus they contribute a mandatory 4% of sales to the McDonald's marketing fund, which is split between local and national advertising. Both of these 4% fees are, like rent, calculated on gross sales at the store level. Finally, the franchisee also bears the costs of equipment upgrades and restaurant refurbishments, which in many cases are mandated by MCD.

The Rising Alienation of McDonald's Owners-Operators

Given the structure outlined above, it is easy to imagine that when restaurant level cash flow is declining, franchisees are unhappy. They feel the pinch. They especially feel alienated - and perhaps even downright angry - when, as has happened lately, MCD Corporate:

- Won't budge on rent when renewing leases, which many owners say have departed too far from the historic average of 8%
- Require franchisees to run promotions like free coffee for several weeks to fight off competition in breakfast
- Expand the "Dollar Menu & More", and then spend funds advertising it: this drives gross sales, but hurts owners' margins because people then don't buy as many more expensive sandwiches
- Require upgrades to equipment like new prep tables that both cost money (estimated at some $15,000 or higher), plus downtime; these new prep tables are largely to accommodate Oak Brook's new menu customization scheme
- Mandate physical restaurant "reimaging", which many owners feel are is both insufficiently flexible, and is being driven on timetable dictated from Oak Brook - to be completed by the end of 2016 - that owners feel is too fast
- Crack the whip on service quality and friendliness, which for owners drive up staffing and training costs

In short, there is a culture problem between MCD and its owner operators brewing. One franchisee recently told Bloomberg: "What I see going wrong is the corporation itself is forgetting that its fiscal strength rides on the fiscal strength and the creativity of the operators, and it's just going for such centralized control." A survey conducted by McDonald's itself in March resulted in franchisees ranking their relationship with Oak Brook as a 1.73 on a scale of 1 to 5 (with 1 being poor, and 5 being excellent). At the end of 2013, the same survey had produced the lowest result ever, with franchisee satisfaction dipping to 1.7.

Can Investors Smell A Spoiling Culture?

As an investor, you can find evidence of growing animosity between MCD corporate and franchise owners in two ways. As I argued in the first piece in this series, the plural of anecdote is not evidence, but there is value in store visits when operational consistency is the name of the game. Evidence for a fraying rapport between franchisees and MCD corporate may be no further away than your local McDonald's. There, you might see or experience things backed up in wider surveys (your second source of evidence):

- **Increasing waiting times in store** - According to the WSJ, in a recent webcast to franchisees, one slide said that complaints about speed of service "have increased significantly over the past six months." Another slide said that customers find service "chaotic". Another baldly stated "Service is broken".
- **Increasing waiting times at the drive through** - A survey by QSR Magazine/Insula Research recently observed that McDonald's recorded its slowest drive-through time in 15 years. In their annual Drive-Thru Study, QSR magazine's comparison of customer service at fast-food chains, average service time at McDonald's drive-through was 188.83 seconds, compared with 129.75 for Wendy's (WEN), the industry leader.
- **Less friendly staff** - In another recent survey, Chick-fil-A had the top friendliness ratings among QSRs. Of the seven major chains considered, McDonald's was second to last in the "very friendly" ranking, just above Burger King (BKW). According Bloomberg, in a recent Oak Brook-Owner webcast, 20% of customer complaints concerned staff friendliness (or lack thereof).

In short, McDonald's is running out of the special sauce needed to make the brand work in the long run - a culture of quality service. A big reason this is happening because MCD's spoiling relationship with its franchisees.

The Actual Sources of Tension?

From a tactical perspective, it's easy to say the source of these problems is declining cash flows at the restaurant level. When they head back up, owner operators will smile again. Here, however, I would argue that investors need to think more strategically. The relationship problems are rooted in the two issues that I have already raised in this series.

First consider Menu Complexity: the sheer range of items McDonald's currently offer impacts efficiency at the store level in numerous ways. It affects day to day operational efficiency in everything from speed of service to order accuracy. It impacts the amount staff training required, and it also impacts turnover - unhappy customers tend to create unhappy staff, which increases turnover, which leads to a vicious cycle of less satisfied customers and irritating, unfriendly and unhelpful staff. It adds to the amount of labor required to deliver any one dollar of food, and it also diminishes economies of scale at the supply chain level. In other words, menu complexity drives costs, and most of these costs are borne by the owners of the franchise.

The link between a broken franchisee relationship and menu complexity was illustrated clearly in a recent survey of 27 McDonald's owners by Janney Capital Markets. Collectively, these franchisees operate over 200 restaurants around the country. Among the anonymous comments offered were, "Free coffee, yeah, that'll do it!" Another said, "Our menu has gotten too big. We are trying to do too many things and our service and quality suffer. Look at In-N-Out Burger, Chick-fil-A, Five Guys. Their menus haven't changed in years and they do not offer discounts on a regular basis." One owner explicitly called the McWrap "an operational nightmare". Another respondent made the link between menu complexity, service problems and cultural problems even more clear, stating, "The menu items introduced during the last year -- McWraps, Quarter Toppers, and Dollar Menu & More sandwiches -- have killed our service and totally upset our kitchens." Another operator said, "Slow kitchen turnaround times; more new products that do not sell." Yet another said "Upper management and supporting departments are out of touch. We're spending like crazy on new equipment. Very little return. We keep adding more products and expecting different results on service times. We are 8-10 seconds slower than last year."

Next, investors should think about food integrity, the idea that MCD is no longer the go-to place for many American soccer moms. Here, the strategic link with long-term franchisee satisfaction is equally clear. Day to day, declining perceptions of MCD's food quality impact owners' ability to raise prices - one of the few key decisions under their direct control. Right now, restaurant owners are having to do the opposite, with one respondent to the Janney survey writing that MCD is "couponing like there is no tomorrow," and another complaining that, "every quarter we sell a smaller percentage of our menu at full (and profitable) price." Specifically on the issue of discounting to drive volume, a franchisee stated that in the long run it, "Won't help. No matter what. There is no way to make all those $1 or $2 sandwiches fast. We could do it when it was just the McDouble and the McChicken. But now with 25 total items, no. If you add crew it doesn't cover the cost to make all the Dollar Menu crap. Haven't sold a wrap in so long. No one remembers how to make one." In the short run, of course, profitless volume keeps Oak Brook happy because they make their money on each restaurants' gross, not net, sales.

But MCD's food integrity problem also hits franchisees in the long run. It does so by reducing the total addressable market size for each location. As more and more of the US middle class decides that MCD's ingredients are not grown, processed and delivered in a healthy enough manner for their families to eat regularly, the value of each franchise declines. As greater numbers of Americans switch to restaurants perceived as more "natural", "simple" and "healthy", (i.e. concepts like Chipotle (CMG), which is built on this trend), McDonald's franchisees lose out. This will be a slow process, but because franchisee satisfaction is driven so largely by cash flow, it is a critical strategic challenge that initiatives like menu customization ignores.

The Way Forward

In other words, the way for Oak Brook to fix the culture of dissatisfaction among owners (which will help customer satisfaction and operational efficiency) is for them to focus on menu simplification and food integrity. Instead of nibbling away at the margins of these issues, trying to be all things to all people, and announcing share buy-backs for a short term boost, MCD needs to take drastic action on these core strategic issues.

For investors, the key to the long term performance of MCD shares is these three linked "meat and potato" operational issues: menu complexity, food integrity, and franchisee tension. Until Oak Brook comes up with a plan that jointly addresses these, expect MCD's share price to languish.

Disclosure: Milo Jones was long MCD, KRFT, MO, and XOM at the time these pieces were published, and may retain these positions.

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