

## Ronald, Reanimated

Appointed in March, McDonald's new CEO, Steve Easterbrook, has already done much to innervate a culture that had long risked growing ossified. As the company's latest quarterly reports attest, investors may be cautiously optimistic that this new management's focus has come to bear.

Till recently, however, it would appear that this change had gone largely unnoticed. While in the US, McDonald's same-stores sales topped expectations by 1%, globally, same-store sales grew 4%, more than double what consensus expected. This resurgence can, at least in part, be attributed to Mr. Easterbrook's moves to reinvigorate sales. These include paring down the expansive menu, placing greater emphasis on the quality and freshness of ingredients, and allowing regional markets to develop their own products. Going forward, we expect tailwinds from the all-day-breakfast initiative and, in China and Japan, more accommodating same-store sales as food safety concerns are assuaged.

Central to the turnaround plan, however, is a continued shift toward franchising: over the next 3 years McDonald's aims to expand the use of franchise partners to 90% of stores. The appointment of Mr. Easterbrook is thus no coincidence: prior to leaving the restaurant chain in 2011, he headed up UK operations where he aggressively pursued such a strategy. Historically, franchising has proven a successful tactic as, by off-loading capital outlays and fixed costs to the franchisee, both profitability and earnings stability have been boosted, enabling larger dividends and share repurchases.

A new management structure will be implemented, replacing the antiquated system of geographic segmentation with segmentation by common strategic challenges. Moreover, the previously centralised structure will give way to a decentralised organisation where decision making happens at the local and regional level, that is, closer to the customer. Though this may all smack of corporate verbiage, our view is that it is nothing of the sort and should enable managers to quickly identify and address common issues, for instance, handling supply chain problems in developing markets. In our view, the twin strategies of franchising and decentralisation are likely to bear fruit as they place operational complexity and risk in the hands of those best positioned to manage them.

While the most recent results are promising, it should be noted that one quarter results are not indicative of a trend. Nonetheless, the renewed emphasis on franchising and menu simplification is a shrewd move that has proved successful before – indeed, same-store sales growth peaked along with franchising mix in the three years to 2009 – and ought to provide a tailwind to profitability in the coming year. At Credo, we have for a while suspected the onset of such an operational turnaround and, accordingly, have been optimistic about the company's prospects. Now, as sentiment has improved, the stock has outperformed and the valuation is looking fuller. After a moribund few years, McDonald's is finally coming back to life.

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