



HEDGEYE
RESTAURANTS
MCD REVEALS COFFEE STRATEGY FOR 2014
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MCDONALD'S 2014 ANALYST MEETING

THE NEW MANTRA



EVEN BETTER AND BIGGER

- Accelerating unit growth, while trying to fix a struggling core business.
- Classic “Stage 2 Denial”:
 - In an effort to avoid the inevitable and appease the street, management begins to accelerate growth through the form of new units.
 - Normally, the core business continues to deteriorate alongside a decline in ROIIC.

LONG-TERM GROWTH STRATEGY



- Moving forward, menu growth will primarily come from the core categories, including beef, chicken, breakfast and beverage.
- Beverage is the biggest opportunity, but it also has significant challenges.
- Management believes each one of these categories represents a \$2 billion opportunity over the coming years.
- In order to capture the beef and chicken opportunity, MCD must improve store performance. Can this be done while emphasizing items, such as beverages, that slow throughput?
- No change in long-term growth targets (which are now aggressive):
 - 3-5% system-wide sales
 - 6-7% operating income growth
 - High teens ROIIC
 - Incremental unit growth will come from the APMEA region, which has the lowest ROIIC

OPTIMIZING EXECUTION



- The rise of fast casual suggests there is more competition for hiring.
- MCD will refocus their efforts on hiring and retaining the best employees, in an effort to create a better experience for customers.
- An effort to capture incremental market share in the coffee category will also require increased employee training.
- Improving trends at lunch is vital to the future success of McDonald's.
- As we said on Tuesday, we believe MCD's core lunch business has been declining since 2010 and has been masked by the company's successful efforts to sell cold beverages.
- QSR Magazine recently reported that MCD's average speed of service was the slowest in 15 years.
- Slowing remodels to install new "prep tables" in the U.S. store base in an effort to improve the speed of service.
- Globally, 60% of MCD's interiors and 50% of its exteriors have received the company's updated, contemporary look.

- The unit growth engine of the company, but very low ROIIC.
- Of the company's 840 planned new restaurant openings in 2014, approximately 300 are planned for China.
- In 2014, half of the company's new restaurant openings in APMEA will include a drive-thru, including roughly 20-25% of the new openings in China.
- Breakfast is only 13% of APMEA's sales, so there is a significant opportunity to grow this business.



- The bull case for MCD is based on a turnaround in Europe.
- MCD has restructured its European region with a new Managing Director in Germany; Germany sales trends remains soft.
- Today, nearly 100% of MCD European interiors and 80% of exteriors reflect a more relevant, contemporary look; have not seen much of a sales lift from improving assets.
- Breakfast is a big opportunity as only 5% of total sales come from this daypart.
- The company is placing a strong emphasis on growing breakfast; right now, only 50% of the company's restaurants are open for breakfast.
- Breakfast only accounts for 1% of sales in France and 14% of sales in the U.K.



- Slowing the pace of LTOs in 2014.
- Slowing the pace of remodels to enhance in-store execution.
- Will not have the pressure of taking the Angus Burger and the Chicken Selects off the menu.
- 2014 will be a transition year.
- There will be a strong focus on beverages.
- The 2013 new product pipeline did not work – will 2014 be any better?

BEVERAGE OPPORTUNITY



- To quote MCD's senior management at lunch: "We kicked them in the gut in 2005-2006 and we are going to do it again."
- The last time management was able to drive mid-single digit same-store sales was when they launched Frappes & Smoothies.
- While the opportunity looks impressive, execution will be key to driving incremental sales.
- The company is looking to drive high margin, incremental beverage sales to help mitigate the pressure from other lines in the P&L.
- The company did not reveal a go-to market strategy for taking advantage of the beverage opportunity.
- According to MCD, they have 12.8% of the IEO coffee market in U.S.
- They believe coffee is as important as fries; it has higher margins.

BEVERAGE OPPORTUNITY



- Their goal is to enhance the coffee culture at MCD and they will enhance the training of their employees.
- They believe they have a high quality coffee product and loyal consumers.
- Plan to leverage brand McCafe – enhancing marketing calendar support and introducing new flavors.
- More than 70% of coffee consumption in the US takes place at home (including retail sales of premium roast, ground, whole bean and single-serve coffee offerings).
- According to management, “research suggests” that driving greater awareness of the McCafe brand in supermarkets will drive incremental consumers to their stores – thank you Starbucks!
- When will McDonald’s introduce a McCafe branded beverage in supermarkets?



- Management loves the real estate.
- They will not increase leverage to buyback stock.
- There is minimal potential for dividend growth.
- Margin pressure will persist through 2014.
- G&A will increase in 2014, due to increased compensation expenses.
- Implications are that management lowered guidance for 2014.

ANALYST MEETING SUMMARY

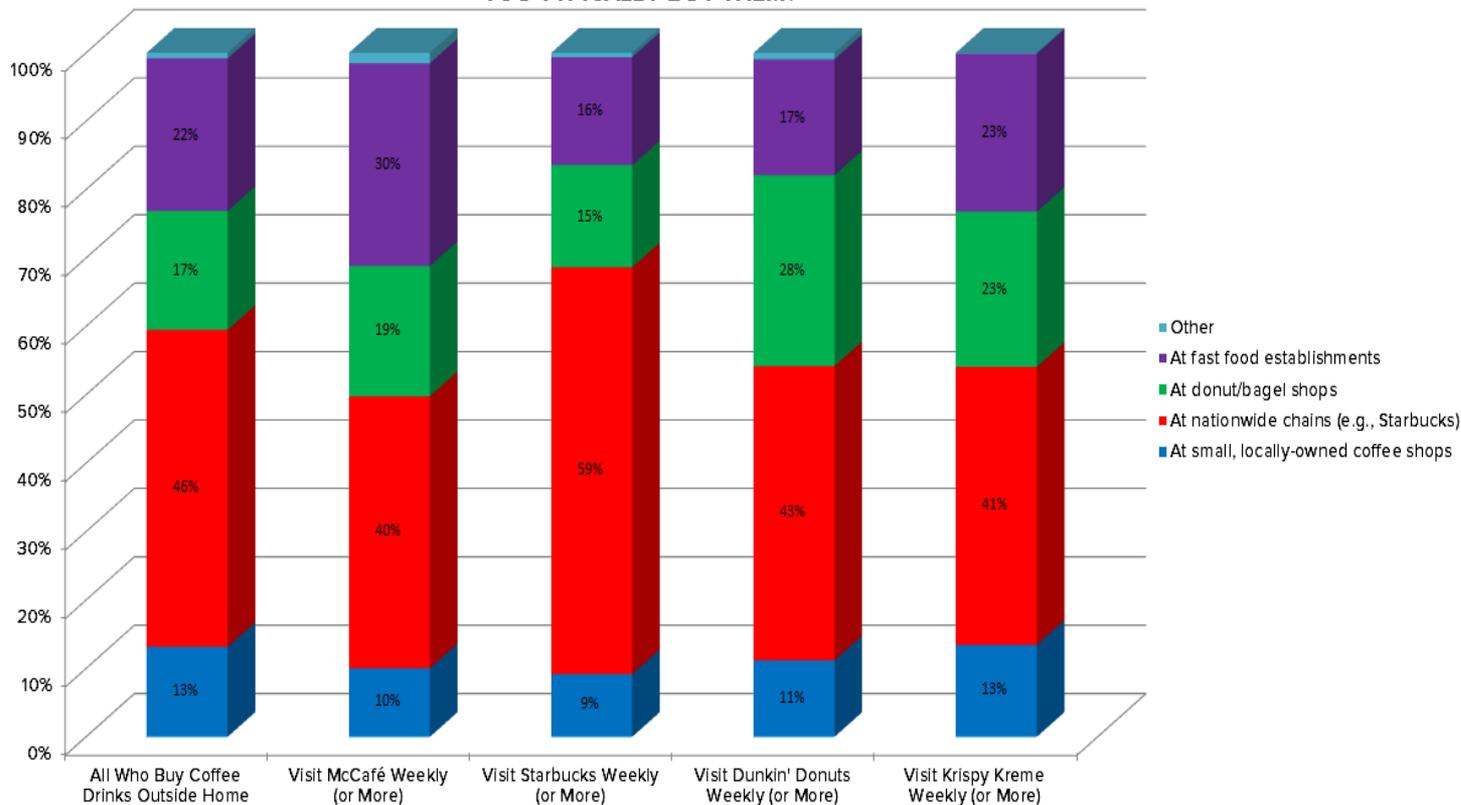


- Overall, there was a feeling of disconnect to the meeting, which started with the “Even Better And Bigger” mantra.
- In our space, we have never seen a company simultaneously get bigger and better while the core business is struggling.
- It is now clear to us that McDonald’s, under CEO Don Thompson, is a company in transition.
- What is unclear to us is how long and expensive this transition will be.

COFFEE BRAND LOYALTY



FOR THE COFFEE (AND SPECIALTY COFFEE DRINKS) THAT YOU PURCHASE, WHERE DO YOU TYPICALLY BUY THEM?



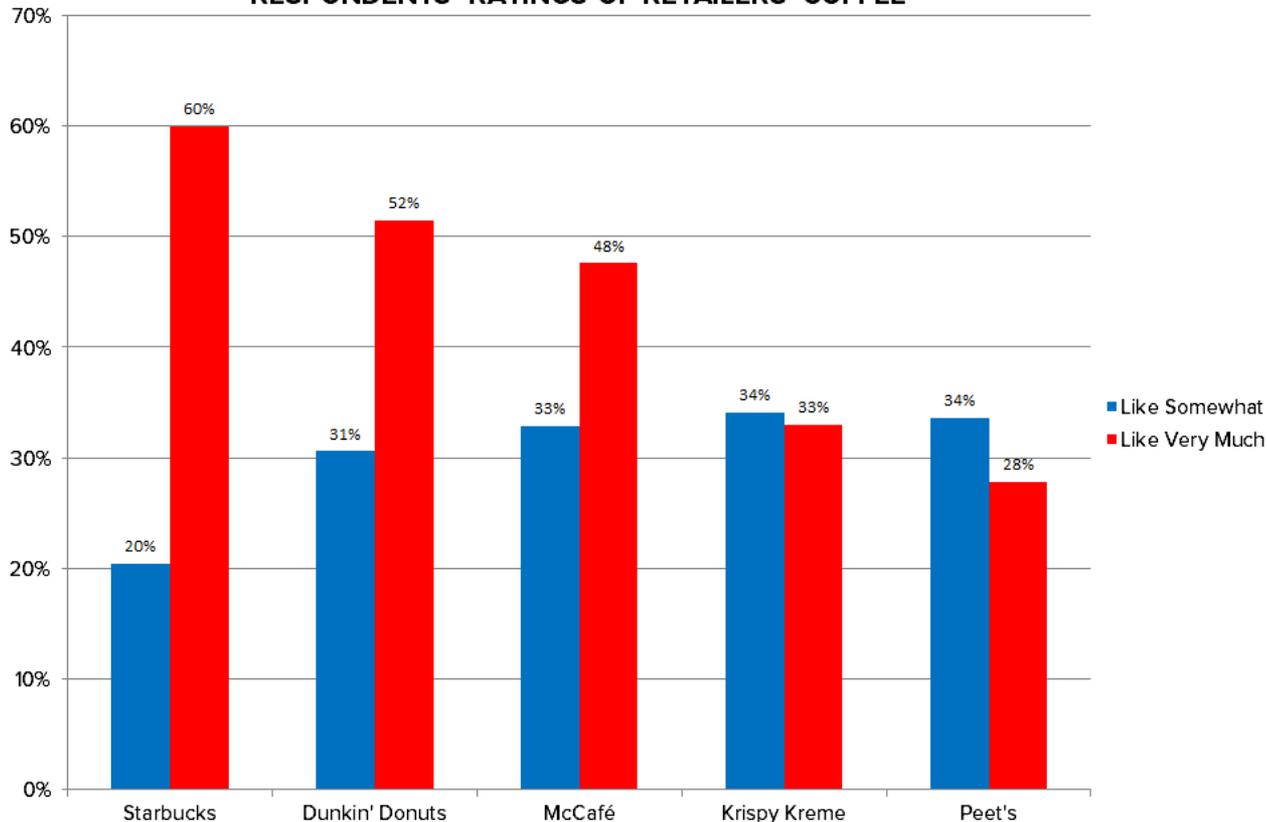
59% of SBUX customers make coffee purchases at coffee chains.

Bottom line: among the people who patronize McCafé at least once a week, 70% are still buying their coffee elsewhere.

COFFEE RATINGS



RESPONDENTS' RATINGS OF RETAILERS' COFFEE



Source: Dectiva, Hedgeye

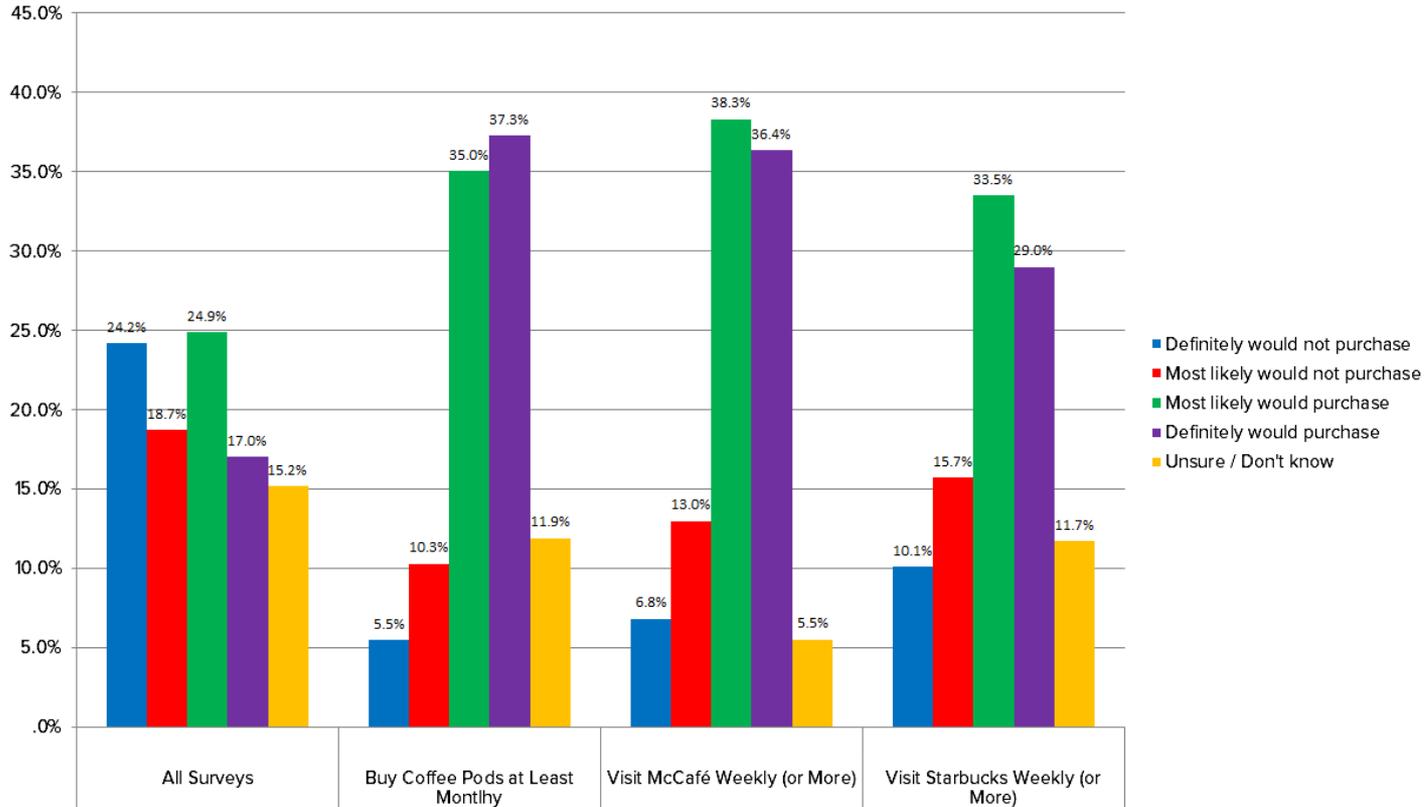
60% of coffee consumers like SBUX coffee “very much.”

This is significant, considering that the overall quality and taste of coffee is the number one factor coffee consumers look for.

High brand loyalty among large brands in the coffee category make it very difficult to take market share.

SINGLE-SERVE MCCAFAE PODS

HOW LIKELY WOULD YOU BE TO BUY SINGLE-SERVE MCCAFAE COFFEE PODS AT GROCERY STORES?



Source: Dectiva, Hedgeye

42% of those surveyed said they would “likely” or “definitely” purchase McCafé (or McDonald’s-branded) individual coffee pods from grocery retailers.

DEMAND DRIVERS: ALL CUSTOMERS

TABLE 1: Rank of Factor Importance Among *All* Individuals who Purchase Coffee Drinks Outside the Home	FACTOR RANK	ALL Consumers Who Buy Coffee Drinks Outside Home	Visit McCafé Weekly (or More) N=308	Visit Starbucks Weekly (or More) N=376	Visit Dunkin' Donuts Weekly (or More) N=261	Visit Krispy Kreme Weekly (or More) N=107	Visit Peet's Weekly (or More) N=68
QUALITY & OVERALL TASTE of COFFEE/DRINKS	1	88.9%	90.9%	90.7%	90.0%	86.9%	92.6%
CLEANLINESS	2	85.0%	87.7%	87.0%	86.2%	86.9%	80.9%
SELECTION of COFFEE DRINKS AVAILABLE	3	76.9%	84.4%	84.0%	84.7%	88.8%	83.8%
QUALITY & OVERALL TASTE of FOOD	4	74.4%	80.8%	77.4%	83.1%	84.1%	79.4%
FRIENDLINESS of BARISTAS/STAFF	5	69.0%	73.4%	75.8%	74.7%	81.3%	72.1%
PRICE	6	66.9%	71.4%	64.9%	66.3%	64.5%	61.8%
HOW QUICKLY I CAN GET IN and OUT	7	63.7%	72.4%	68.9%	69.0%	73.8%	75.0%
PROXIMITY TO HOME	8	60.1%	67.5%	64.9%	67.0%	74.8%	72.1%
WILLINGNESS to CUSTOMIZE	9	59.2%	68.8%	68.1%	69.0%	76.6%	76.5%
COMFORTABLE ATMOSPHERE	10	58.8%	65.3%	67.3%	66.7%	74.8%	73.5%
AVAILABILITY of PARKING	11	54.0%	61.4%	57.4%	64.4%	71.0%	75.0%
SELECTION of OTHER NON-COFFEE PRODUCTS	12	53.4%	67.2%	57.4%	66.3%	73.8%	70.6%
DRIVE-THROUGH WINDOW	13	51.0%	65.3%	55.9%	60.9%	68.2%	72.1%
PROXIMITY TO WORK	14	47.2%	58.1%	60.9%	62.8%	70.1%	66.2%
AVAILABILITY of SEATING	15	45.6%	53.2%	50.8%	51.0%	67.3%	70.6%
HOW EARLY THEY OPEN	16	44.4%	56.5%	55.9%	56.7%	69.2%	67.6%
SEASONAL/HOLIDAY DRINKS	17	41.4%	51.0%	52.9%	54.0%	72.9%	67.6%
NOISE LEVEL	18	40.6%	47.1%	48.4%	49.4%	61.7%	63.2%
IMAGE/BRAND FITS LIFE STYLE	19	33.6%	46.4%	44.7%	47.1%	63.6%	64.7%
FREE WIFI	20	30.0%	40.6%	38.8%	43.3%	64.5%	60.3%
KID-FRIENDLY	21	28.5%	41.2%	36.2%	39.5%	55.1%	52.9%
RECOGNIZE ME/REMEMBER by DRINK PREFERENCE	22	28.3%	37.3%	37.5%	39.8%	57.0%	63.2%

Data Source: Dectiva, Hedgeye

- Quality & Overall Taste of Coffee is the most important factor for coffee customers.
- Cleanliness, selection of coffee drinks available, quality and overall taste of food, and the friendliness of baristas/staff round out the top 5 most important factors for coffee consumers.

DEMAND DIFFERENTIATORS



FACTOR RANK	McCafe	SBUX	DNKN	KKD	PEET
1	Quality, Cleanliness, Selection, Food, Friendliness, Speed of Service.				
2					
3					
4					
5					
6					
7	P	C	C		
8	C				
9					
10		P			
11			P		
12					
13					
14					
15					
16					
17				P	
18					
19					
20					P
21					
22					
	IDENTICAL				
	CUSTOMIZATION				
	PRICE				

- McCafe customers value price more than customization.
- The majority of other customers value customization more than price.
- MCD's strategy to take market share by offering a lower price point will not work.
- MCD can not match the level of customization that these other chains offer.



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