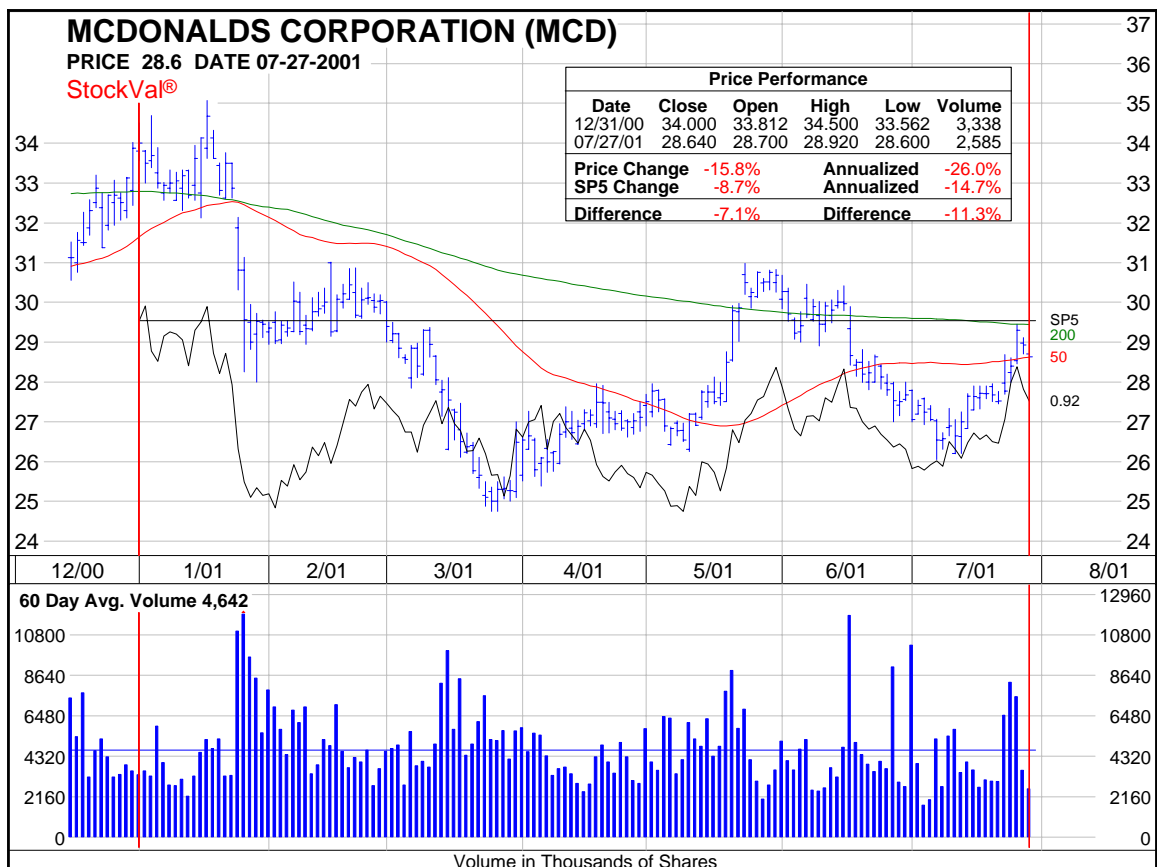


Is There An Investment Opportunity Under the Golden Arches?

McDonald's Corporation is the largest foodservice retailer in the world with over 28,000 restaurants in 120 countries, serving over 45 million people a day. Remember when Company signs tallying total number of customers ever served was still in the millions? The super-sized Company truly possesses a global presence with 55% of their restaurants now residing outside of the United States. Size and a worldwide marketplace have not made the Company immune to its share of recent difficulties.

The Company's June 2001 quarter marked the third straight period of declining year-over-year numbers. The second quarter earnings per share of \$0.34 met estimates. However, those numbers had been guided lower by management in June. McDonald's Corporation has been hurt by several overseas developments; including a weak Euro and European beef supply concerns. Additionally, vegetarians filed a lawsuit claiming that the Company has been adding beef flavoring to its fries for years.

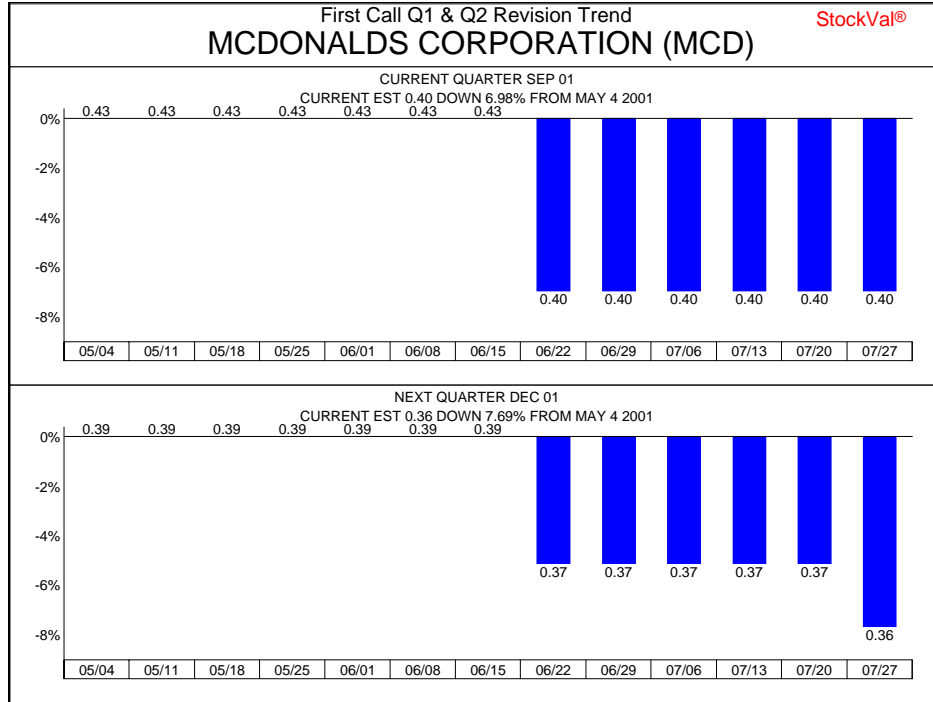
So where does the food retailer stand today; poised for a rebound or languishing with a diminishing growth rate future? This paper will attempt to explore the analytical issues surrounding the Company.



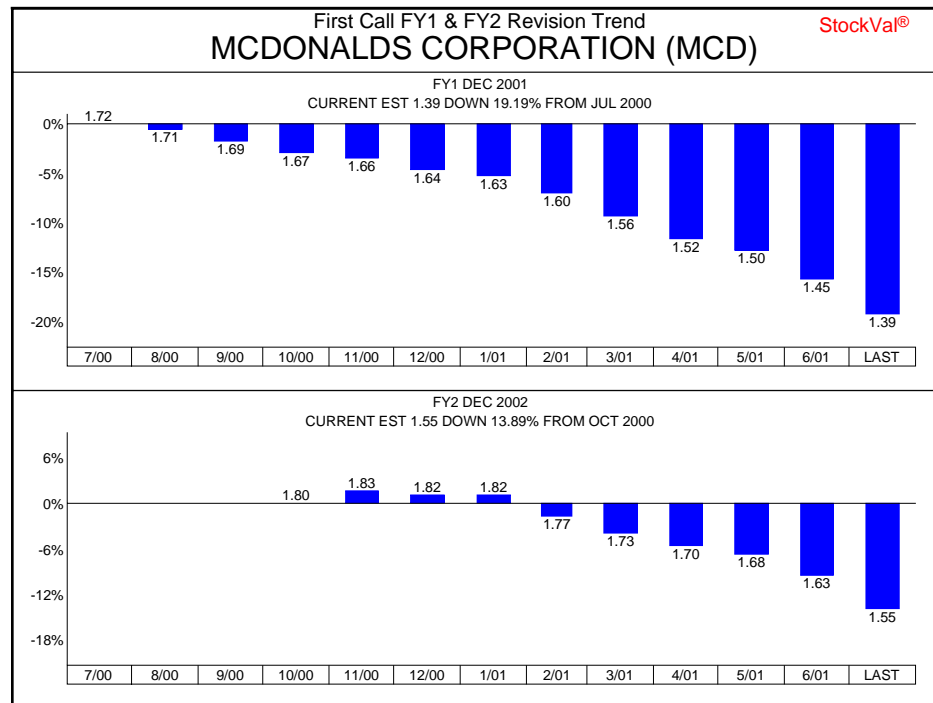
As the above graph indicates 2001 has been a difficult year for McDonald's price performance, shedding 15.8% and trailing the Standard & Poors' 500 Composite by 7.1%.

Estimates

Should the September 2001 earning's estimates come in at \$0.40; it would represent four straight quarters of negative year-over-year growth. September and December 2001 quarter estimates fell when the Company announced the June quarter warning.



Estimates for December 2001 have fallen every month over the last year. December 2002 numbers have slid as well.



StockSelect Report

The following screen compares various valuation measures of McDonald's and its peers. Its peers are defined as moderately priced, casual, family-style restaurants with regional and national presence across the United States.

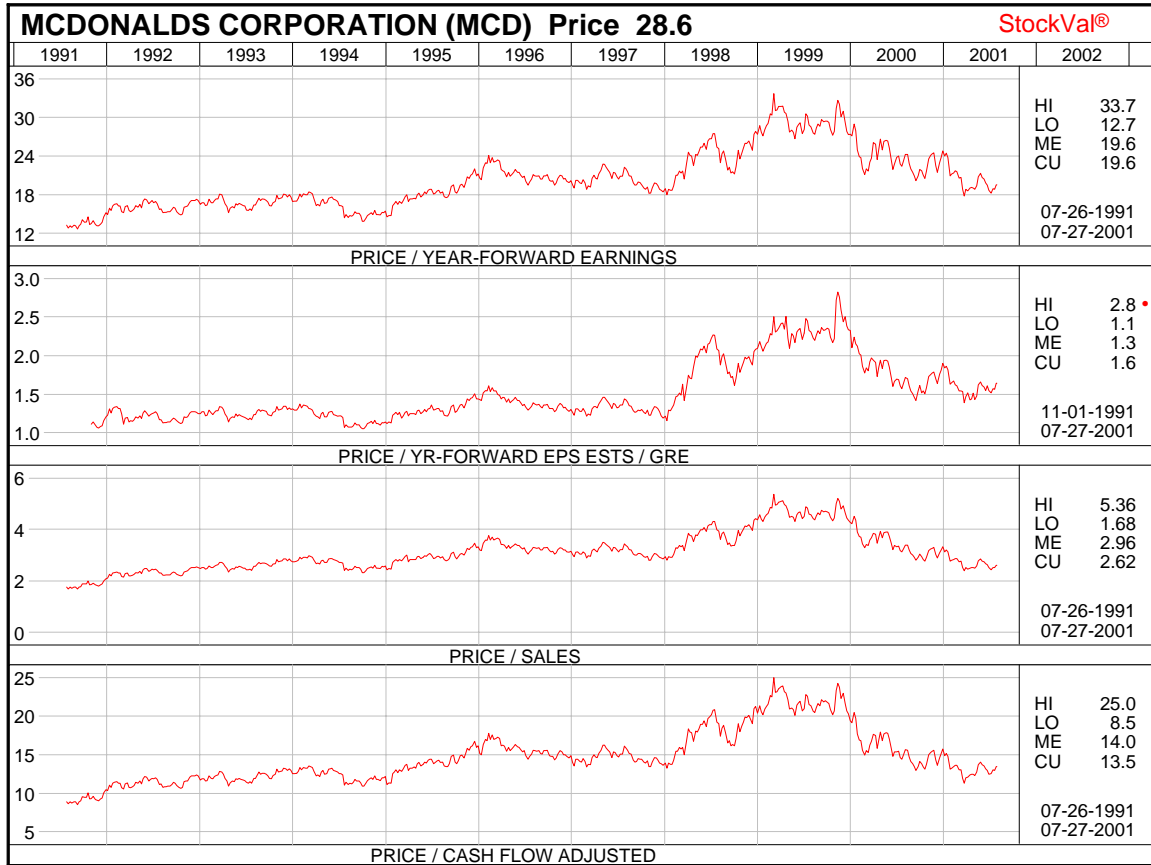
Stock Name	Symbol	PE F12M Est	PE F12M Est/GRE Median	Price / Sales	Price / Adjusted CashFlow	Price / Book Value	Ent Value / Sales	Dividend Yield	Growth Estimate Median
APPLEBEES INTERNATIONAL INC	APPB	14.9	1.0	1.63	11.37	4.13	1.7	0.25	15
BLIMPIE INTERNATIONAL INCORPORATED	BLM	NEG	NEG	0.51	10.03	0.85	0.2	4.12	40
BRINKER INTERNATIONAL INC	EAT	15.3	0.9	1.07	11.04	3.01	1.1	0.00	17
CALIFORNIA PIZZA KITCHEN INC	CPKI	26.1	1.0	1.80	16.66	4.24	1.8	0.00	25
CEC ENTERTAINMENT INCORPORATED	CEC	14	0.6	1.85	10.30	3.25	2.0	0.00	23
CHART HOUSE ENTERPRISES INC	CHT	2.4		0.11	99.99	0.35	0.3	0.00	
CHECKERS DRIVE IN RESTAURANT	CHKR	12.5	0.7	0.38	4.42	1.31	0.7	0.00	17
CKE RESTAURANTS INCORPORATED	CKR	NEG	NEG	0.13	5.48	0.70	0.5	0.00	10
DARDEN RESTAURANTS INCORPORATED	DRI	15.7	1.0	0.89	11.21	3.44	1.0	0.28	16
ELXSI CORPORATION	ELXS	6		0.36	4.98	0.48	0.5	0.00	
FRESH CHOICE INCORPORATED	SALD	NEG	NEG	0.25	3.31	0.93	0.3	0.00	
FRISCHS RESTAURANTS INCORPORATED	FRS	9.6	1.0	0.36	4.43	1.21	0.5	2.42	10
GARDEN FRESH RESTAURANT CORP	LTUS	6.7		0.18	2.44	0.46	0.4	0.00	
IHOP CORPORATION	IHP	13.6		1.86	11.53	2.13	2.6	0.00	
J ALEXANDERS CORPORATION	JAX	10.3		0.16	3.05	0.37	0.4	0.00	
JACK IN BOX INCORPORATED	JBX	11.2	0.7	0.61	7.59	2.97	0.8	0.00	17
LANDRY'S RESTAURANTS INCORPORATED	LNYS	15.8	1.3	0.63	7.51	1.11	0.8	0.54	12
LONE STAR STEAKHOUSE/SALOON	STAR	12.0		0.47	7.23	0.61	0.4	4.58	
LUBYS INCORPORATED	LUB	11.6		0.44	10.33	1.11	0.7	4.37	
MCDONALDS CORPORATION	MCD	19.4	1.6	2.62	13.48	4.25	3.1	0.75	12
OUTBACK STEAKHOUSE INCORPORATED	OSI	13.4	0.8	1.10	11.08	2.64	1.0	0.00	17
PAPA JOHNS INTERNATIONAL	PZZA	11.2	0.6	0.59	7.08	3.33	0.7	0.00	18
PICCADILLY CAFETERIAS INCORPORATED	PIC	1.6		0.03	99.99	0.25	0.2	0.00	
PJ AMERICA INCORPORATED	PJAM	10.2	0.6	0.34	5.41	1.28	0.3	0.00	17
QUALITY DINING INCORPORATED	QDIN	8.6		0.15	2.47	0.82	0.6	0.00	
RUBIOS RESTAURANTS INC	RUBO	42.2	1.7	0.45	8.82	1.05	0.4	0.00	25
RUBY TUESDAY INCORPORATED	RI	16.9	0.8	1.43	12.13	4.41	1.5	0.24	20
RYANS FAMILY STEAK HOUSE	RYAN	10.6	1.0	0.68	6.91	1.74	0.9	0.00	11
SCHLOTZSKYS INCORPORATED	BUNZ	16.9		0.86	11.80	0.71	1.4	0.00	
SHONEYS INCORPORATED	SHOY	NEG	NEG	0.04	1.72	99.99	0.4	0.00	
SIZZLER INTERNATIONAL INCORPORATED	SZ	3.2	0.3	0.17	3.68	0.77	0.1	0.00	10
SONIC CORPORATION	SONC	18.1	0.9	2.66	14.51	4.44	3.0	0.00	20
STEAK N SHAKE COMPANY	SNS	10.9	0.9	0.61	7.10	1.65	0.7	0.00	13
TRIARC COMPANIES CL A	TRY	22.4	1.2	5.22	99.99	2.14	0.5	0.00	19
TRICON GLOBAL RESTAURANTS INC	YUM	13.0	0.9	0.94	8.25	99.99	1.3	0.00	15
UNO RESTAURANT CORPORATION	UNO	9.9		0.43	5.15	1.29	0.7	0.00	
WENDYS INTERNATIONAL INC	WEN	14.7	1.1	1.43	10.76	2.89	1.6	0.90	14
Median		12.5	0.9	0.59	8.25	1.31	0.7	0.00	17
Mean		13.4	0.9	0.90	15.49	7.20	0.9	0.50	17
Mean Mkt-Cap Wtd		17.3	1.3	2.02	12.87	13.52	2.3	0.54	14

McDonald's stock is trading at the expensive end of several valuation measures.

StockSelect is a facility within the StockVal system enabling users to perform screening or report writing utilizing over 900 data items. Screening can be accomplished by establishing constraints on one or more of the data items selected. Report writing can be performed on a predetermined list or grouping of stocks.

Valuations

The valuation charts below expand on the latest statistics from the previous page to provide a visual historical trend display of the last ten years. The four valuations observed below are mixed with one at the median, one above and two below. All are off sharply from 1999's historic high levels.



Price/Year Forward Earnings (Current Price Divided by an Earnings Point One Year Forward Interpolated Between Actual Earnings and Estimates) - McDonald's is currently trading right at the ten-year median.

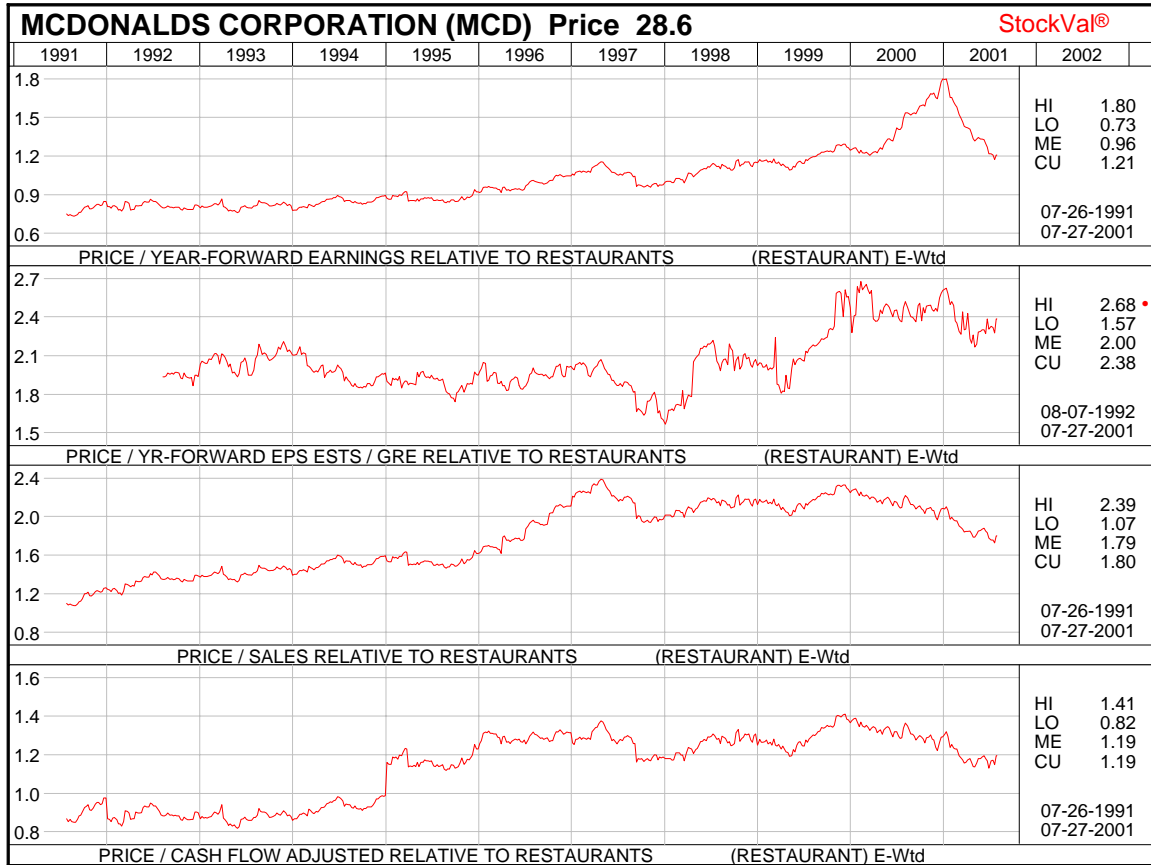
Price/Year Forward Earnings/Growth Rate Estimate - Current valuation is still resides above its median.

Price/Sales - The present valuation measure of 2.62 is now below the median.

Price/Cash Flow Adjusted - As was the case with Price/Sales, the current value has trended lower than its median.

Relative Valuations

Adding a comparison benchmark neutralizes equity discount rate changes and provides a better gauge of valuation levels; with the restaurant members of the earlier screen serving as a peer group. All of the relative valuations, with the exception of Price/Year Forward Earnings, are trading essentially at ten-year medians.



Relative Price/Year Forward Earnings – Despite slipping sharply, the relative valuation is presently still well above the median value.

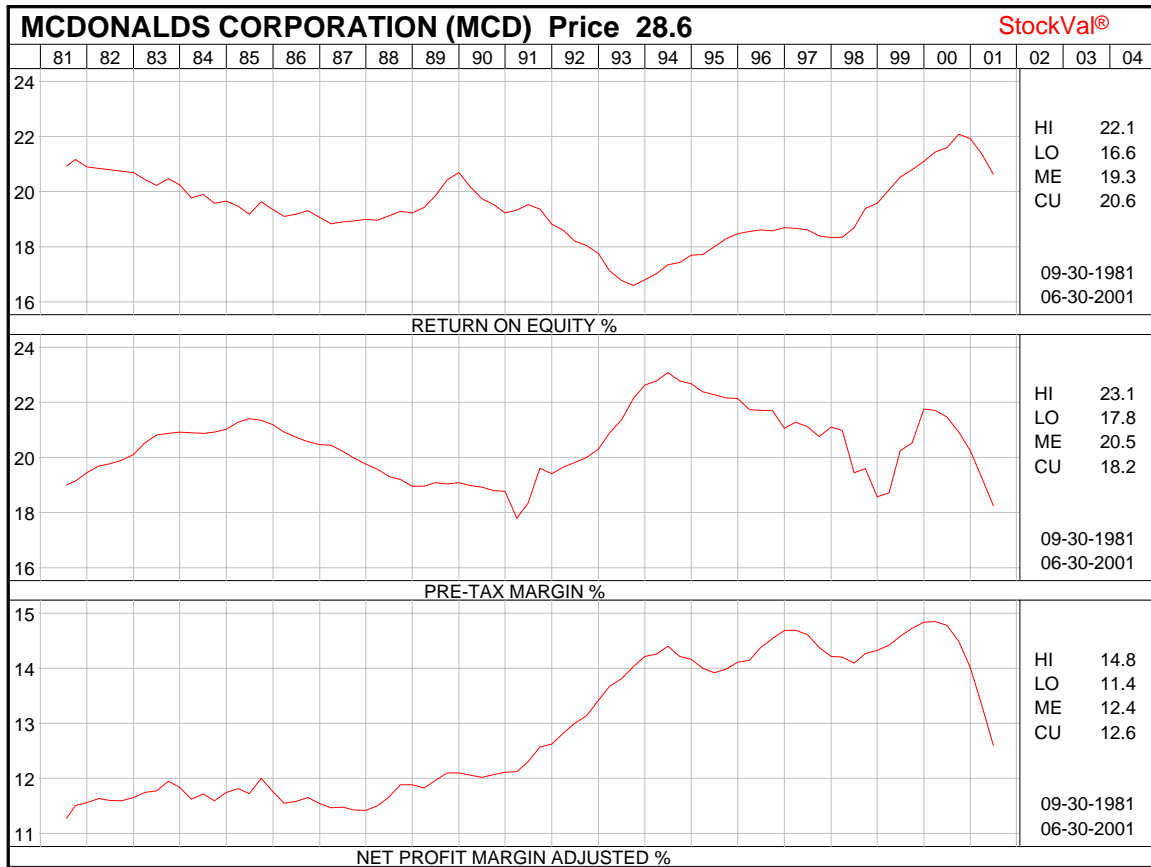
Relative Price/Year Forward Earnings/Growth Rate Estimate – The direction over the last several months has been upward.

Relative Price/Sales – The measure is essentially at the ten-year median.

Relative Price/Cash Flow Adjusted – McDonald's is exactly at its relative ten-year median.

Profitability

All of the observable profitability ratios have declined sharply over the most recent periods.



Return on Equity – This measure trended up for seven years before peaking at a twenty-year high in the third quarter of 2000. However, since that time return on equity has retreated over the last three periods.

Pre-Tax Margin (Pre-Tax Income Divided by Revenue) -- After staging a rally in 1999, pre-tax margin has fallen. Mid-1994 saw a twenty-year high of 23.1%.

Net Profit Margin Adjusted% (Net Income Adjusted Divided by Revenue) – Values ranged from 11% to 12% before surging throughout the '90s. A peak was reached in early 2000 before falling very sharply. Is the recent fall only temporary or are the 11% to 12% margins of 1981 to 1990 the normal range?

Historic and Forecasted Growth Rates

Growth & Margin Check											StockVal®	
MCDONALDS CORPORATION (MCD)											Default Growth Rate Estimate 10.8%	
Price 28.640 07/27/01											Analyst Growth Rate Estimate 10.8%	
Quarter	Revenue	Percent Change				Actual EPS	Year Ago	Profit Margin %	SF	Momentum %		
		REV	RPS	EARN	EPS					REV	EPS	
Sep	3,444.2	7	8	10	11	0.39	0.35	15.9	0	+7	+12	
Dec*	3,372.9	5	6	8	9	0.35	0.32	14.5	0	+5	+9	
Mar	3,343.8	10	12	12	14	0.33	0.29	13.7	+1	+9	+11	
Jun	3,560.6	5	8	2	5	0.39	0.37	15.0	0	+5	+6	
Sep	3,749.0	9	13	1	5	0.41	0.39	14.7	0	+9	+5	
Dec*	3,589.6	6	12	-7	-3	0.34	0.35	12.7	-1	+6	-3	
Mar	3,511.7	5	10	-16	-12	0.29	0.33	10.9	0	+5	-11	
Jun	3,707.5	4	8	-16	-13	0.34	0.39	12.0	0	+4	-14	
T4Q	14,557.8	6	11	-9	-5	1.38		12.6				
Sep		Mean Estimate Next Quarter				-2	0.40	Long-Term Growth Rate Estimates				
		High Estimate				5	0.43	Median Estimate				11.8%
		Low Estimate				-15	0.35	Number of Estimates				10
		Number of Estimates				14		Standard Deviation				1
		Point-to-Point Growth Rates (%)						Least Squares Growth Rates (%)				
	Years	REV	RPS	EARN	EPS	Years	REV	RPS	EARN	EPS		
	1	6	11	-9	-5	1	5	10	-13	-9		
	3	7	9	3	5	3	7	9	4	6		
	5	7	9	4	6	5	7	9	6	7		
	7	10	10	7	8	7	9	9	8	9		
	10	8	9	8	9	10	9	10	10	11		
	15	9	10	10	11	15	9	10	11	12		
	20	10	11	10	11	20	10	11	11	12		

Forecasted Growth

McDonald's median long-term growth estimate from First Call is 11.8%. The standard deviation of one indicates a tight range among the ten analysts supplying data. StockVal lowers analysts' estimates by a portion of its standard deviation to compensate for the optimism of analyst forecasts in creating the Default Growth Rate Estimate of 10.8%. The Analyst Growth Rate reflects any changes by the user; otherwise the number will be the same as the Default.

Historical Growth

Short-term growth over the last three quarters has been negative and if the September quarter comes in line with estimates it would make four. The latest quarters have hurt long-term growth rates. Growth rates have been slowing considerably from a twenty-year to a three-year period on both point-to-point and least squares basis.

Bottom-line growth, earnings and Earnings Per Share (EPS), had been in line with top-line growth, revenues and Revenues Per Share (RPS) over the ten, fifteen and twenty year periods. However, that has not been the case with seven-year and more current time frames. Seven, five, three and one year top-line growth has exceeded bottom-line growth; indicating profit margins are now contracting.

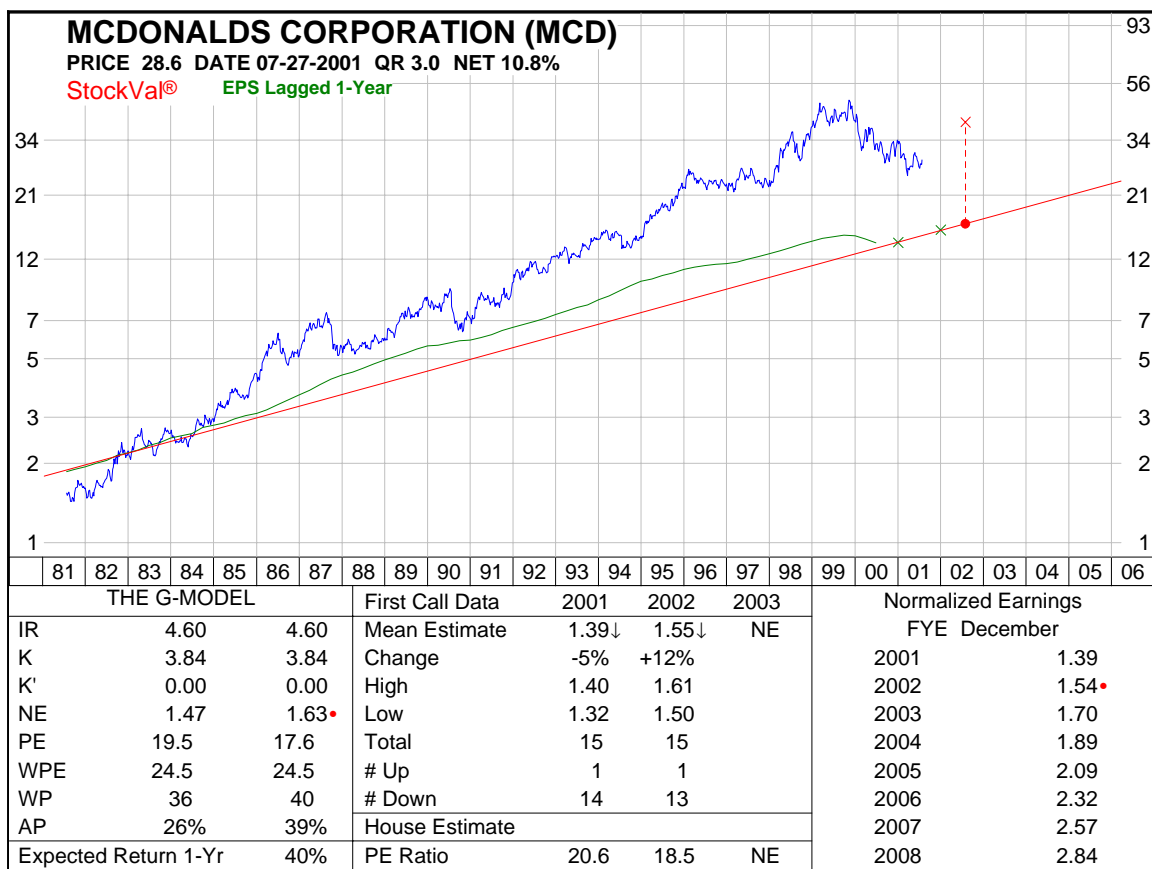
RPS and EPS growth statistics have been greater, or less negative, than have revenues and earnings, respectively. This is an indication of a strong share buyback program. Management has effectively "hidden" a portion of their earnings growth problems. Can the earnings management continue into the future?

Present Value Modeling

StockVal's G-Model is an equity valuation tool incorporating macro- and company-specific factors to provide an interactive present value model. The model incorporates the five-year Treasury rate, market-implied equity risk premia, Earnings Per Share (EPS) forecasts, a long-term growth rate forecast and a company quality rating into its present value calculations to derive a theoretical fair market value (each variable is discussed more thoroughly in the Appendix). Additionally, the G-Model can be used to explore other analytic issues; such as forecasting the impact of changes to a pricing input factor or "backing out" a market-implied growth rate.

For this analysis, the five-year Treasury rate used is 4.60% and the equity risk premium is 3.84. One-year forward interest rates and equity risk premium are assumed to be neutral and left unchanged. These macro-factors can be adjusted, but are market-driven and can be considered to be an accurate model input unless forecasting is to take place.

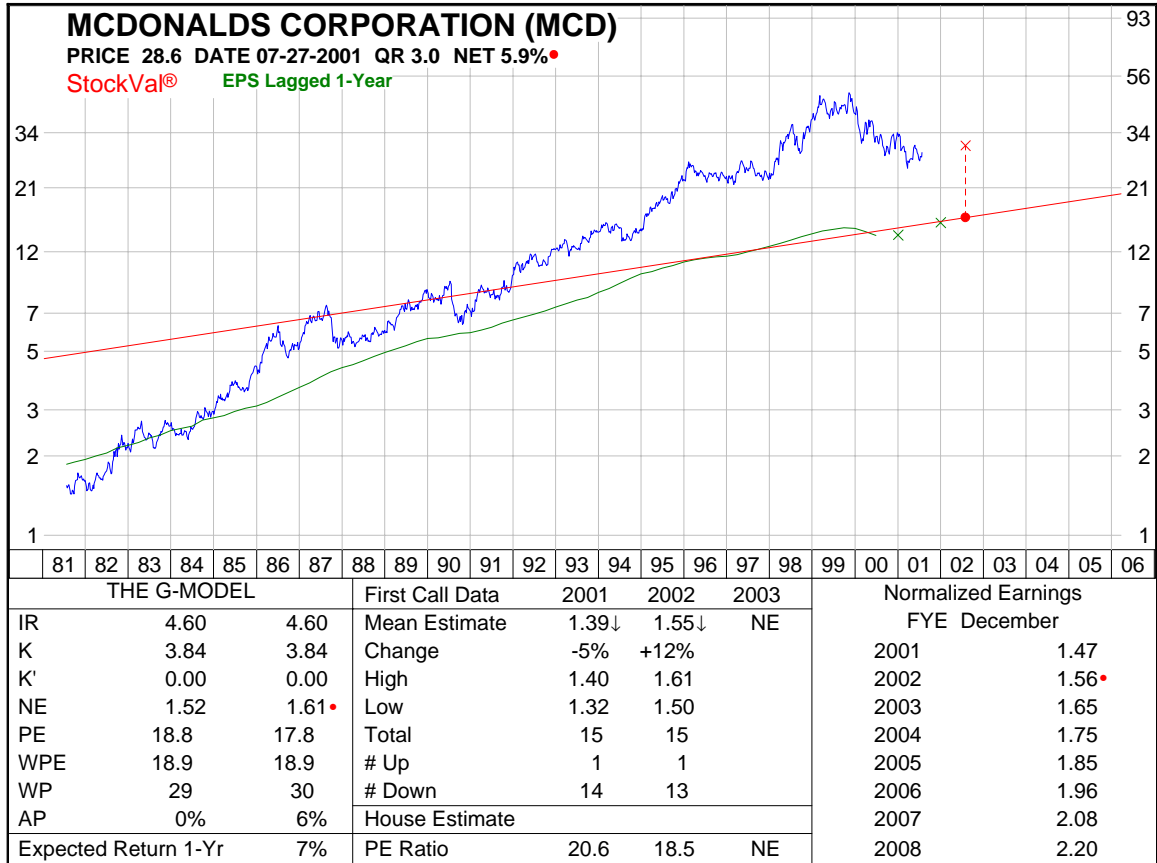
Earnings estimates are considered to be a fairly accurate portrayal of the stock's expectations given the amount of analyst coverage and the extensive use of management guidance in general. The 3.0 quality rating appears to be a reasonable value. Only companies with absolutely pristine attributes would be rewarded with a higher (less than 3.0) quality rating. McDonald's has had very good margins and profitability, but the quality rating seems justified.



The graph above is in default mode and merely a starting point for analysis and should not be considered as an ending price for valuation. It is always critical that user assumptions be applied to the modeling process. All input variables should be analyzed to ensure the validity of each and modify if necessary.

Market-Implied Growth Rates

The last model input, long-term growth rate, needs further analysis. Given the recent historical growth rates (page seven) it seems that the estimate service's 11.8% growth could be considered very optimistic. Even when the last three quarters of negative growth is eliminated from consideration, growth is still slowing. EPS growth for the years 1991 through 1998 was 11.8%, while the 1994 through 2000 period slowed to 9.1%.



Adjusting the Appreciation Potential (AP) to zero, while maintaining the normalized earnings fulcrum point in line with estimates, derives the 5.9% market-implied growth rate. The implication is that if McDonald's can revert back to growing earnings anywhere near estimates and historical numbers potential profits could be in store.

Can the Company find other markets, new taste menu items or new investments to increase growth? McDonald's has owned the little kids' market with its combination of Kid's Meal toys and PlayPlace playgrounds and is unlikely to get even more market share expansion from this segment. Is it likely that more Boston Chicken-type purchases could add significantly to the bottom-line?

Summary

- The Company has been a market under-performer in 2001.
- Overseas earnings numbers have been hurt by the strong U.S. dollar.
- European beef concerns have limited restaurant visits on the Continent.
- Estimates for September 2001 and December 2001 fell when McDonald's issued warnings for their June 2001 quarter.
- Fiscal 2001 and 2002 earnings estimates have been steadily sliding every week since both estimates were released.
- Current valuations are now in the close range of their ten-year medians.
- Many current valuations of McDonald's are right at ten-year medians relative to a select group of its restaurant peers
- Profitability measures have had sharp declines over the last year with severe margin contraction.
- Three straight quarters of negative year-over-year growth have been registered.
- Long-term growth rates have been falling over time.
- Bottom-line growth has fallen much more severely than has top-line growth.
- EPS deterioration has been masked by the Company's use of share buyback.
- McDonald's is being valued as if it is a 5.9% growth company.

Conclusion

Two factors that sharply lowered European profits in 2001 appear to be subsiding. European beef supply concerns over mad cow and foot-and-mouth diseases seem to have passed and the dollar's relative strength to the Euro should be less of a concern going forward.

A distinction could be made here between a great company and a great investment. Investors should not expect to be assisted by valuation multiple expansion. Valuation levels will not recapture the market excesses of the 1998 through 2000 period. To get investors to sing the Company's "We Love to See You Smile" slogan, two areas need to be addressed: declining growth rates and margin erosion.

J. Clifford, CFA

Sources: First Call, McDonalds and StockVal

Appendix One

Background - Five Factors of the Model

Macro-factors used in the model are the **Five-Year Treasury Rate** and a **Market-Implied Equity Risk Premium**. The five-year Treasury rate was chosen because it appears to explain more of the price movement in stocks over long periods of time than other interest rate periods. The equity risk premium is the assumed excess return that investors require beyond the risk-free rate. The G-Model utilizes current and one-year forward interest rates and equity risk premiums. This allows for the user to make predictions or to leave the macro-factors unchanged in a “neutral” position.

EPS Forecasts are interpolated points 12- and 24-months forward utilizing Fiscal Year 1, 2 and 3 EPS estimates. Users with differing opinions than estimate service analysts can put override estimates of their own into the model.

Company-Specific Quality Ratings are based on profitability measures. Ratings range from 1.0 (highest quality) to 5.0 (lowest quality). The quality rating of a company is factored into the model as an adjustment to the equity risk premium. A high quality stock results in a subtraction from its discount rate resulting in higher valuations. A low quality stock would get an addition to its discount rate, which would derive a lower warranted price. The default value for most stocks is 3.0, but the user can assign a different value.

The default value for **Growth Rate Estimates** is the number supplied by the estimate service toned down by a factor of the standard deviation. The downward adjustment to the forecasted numbers is conducted because sell-side analysts are typically optimistic.

Growth Rate Adjustments

Users must scrutinize the growth rate estimates and examine the historical revenue and earnings growth of the company to supply a more accurate number in the majority of cases. Considering all of the input factors, the examination and possible adjustment of long-term growth rates is the single most important factor in modeling growth companies. However, this does not hold true for all companies. An earnings estimate adjustment is the most significant item to analyze when modeling is conducted for cyclical companies.