

Buried Treasure: Finding Information Nuggets in 10-Ks and 10-Qs



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Case Study: McDonald's Corporation

1. We are continuing the Case Study from our “Press Release” Conference Call on 14 July 2004.
2. Case Study Company: McDonald's Corporation
3. Press Release of McDonald's Focused on
 - Renewed strength of company's profitability per store in current and constant currencies
 - Plan to Win Strategy meeting growth targets
 - Salads Plus menu contributed to growth in profitability (but we never found how much of an impact... And in what proportion of total sales?)
4. And the story continues with the release of the 10Q Report dated 31 March 2004

Webcast Agenda

1. Introduction & Introduction to Case Study: McDonald's Corporation
2. Doing Your Homework: Advance Preparation for the 10Q Release
 - Review 10K Report
 - Maintain Historical Financials in Spreadsheet
 - Create Common-Size Financial Statements in Spreadsheet
 - Extract Conclusions on What Is the “Real” News Peg
3. Reviewing the Cash Flow Statement and Determining What it Really Says
4. Process for Reading 10Q Reports
5. Developing More Detailed Questions for Management—Questions Beyond the “Vague” Legalese Language
6. Questions & Answers

Doing Your Homework: Advance Preparation for the 10Q Release

1. Know the most recent 10K Report

- The 10Q is a key update to the 10K. You need some initial context of comparison.
- In particular, read the “Key Risk Factors” section on what can hurt the company’s operations, and thus, the stock price. Watch for these factors in the 10Q Filing.

Doing Your Homework: Advance Preparation for the 10Q Release

2. What did we learn from the 10K Report & from our last conference call?

- The Company redefined its strategy to focus on more customers to existing restaurants via a plan they named “Plan to Win”
- For 2005 and beyond, sales growth targets of 3–5% and operating income growth of 6–7% (the company met)
- High percentage of sales overseas—60–70% implying currency hedging strategy as vital as adding more customers

Doing Your Homework: Advance Preparation for the 10Q Release

3. For more in-depth analysis, maintain a 12-quarter or annual (or longer) rolling history of the income statement, balance sheet, and cash flow statement in an Excel spreadsheet.
 - Look for trends the press release may not highlight
 - Review Cash Flow Statement and Balance Sheet in particular because Income Statement is only half of the story

McDonald's Corporation

Income Statement (1996–2003)

	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Total Revenues	10,686.50	11,408.80	12,421.40	13,259.30	14,243.00	14,870.00	15,405.70	17,140.50
Cost of Sales with Depreciation	4,080.60	4,444.60	4,838.20	5,192.70	6,832.20	7,352.70	7,668.50	8,532.30
Selling, Gen. & Administrative Expense	3,276.20	3,475.60	3,678.80	3,895.90	4,277.50	4,562.90	4,791.00	5,244.40
Income b/f Depreciation (EBITDA)	3,329.70	3,488.60	3,904.40	4,170.70	4,144.00	4,040.70	3,997.00	4,512.00
Depreciation	742.90	793.80	881.10	956.30	1,010.70	1,086.30	1,050.80	1,148.20
Operating Income after Deprec.	2,586.80	2,694.80	3,023.30	3,214.40	3,133.30	2,954.40	2,946.20	3,363.80
Earnings from Equity Interest	0.00	0.00	0.00	0.00	0.00	61.50	24.10	36.90
Other Income, Net	6.70	76.90	19.50	84.90	178.90	(148.10)	(172.90)	(313.20)
Other Special Charges	0.00	0.00	0.00	(18.90)	0.00	(85.70)	(761.20)	(353.10)
Overall Operating Income (EBIT)	2,593.50	2,771.70	2,721.20	3,280.40	3,312.20	2,782.10	2,036.20	2,734.40
Interest Expense	342.50	364.40	413.80	396.30	429.90	452.40	374.10	388.00
Pre-Tax Income (EBT)	2,251.00	2,407.30	2,307.40	2,884.10	2,882.30	2,329.70	1,662.10	2,346.40
Income Taxes	678.40	764.80	757.30	936.20	905.00	693.10	670.00	838.20
Net Income from Total Operations	1,572.60	1,642.50	1,550.10	1,947.90	1,977.30	1,636.60	992.10	1,508.20
Inc. from Cum. Effect of Acct Chg	0.00	0.00	0.00	0.00	0.00	0.00	(98.60)	(36.80)
Total Net Income	1,572.60	1,642.50	1,550.10	1,947.90	1,977.30	1,636.60	893.50	1,471.40
Total Common Shares Outstanding	1,389.20	1,371.40	1,356.20	1,350.80	1,304.90	1,280.70	1,268.20	1,262.00
Treasury Shares	271.40	289.20	304.40	309.80	355.70	379.90	392.40	398.70

McDonald's Corporation

Balance Sheet (1996–2003)

Assets	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Cash and Equivalents	329.90	341.40	299.20	419.50	421.70	418.10	330.40	492.80
Accounts Receivable	495.40	483.50	609.40	708.10	796.50	881.90	855.30	734.50
Inventories	69.60	70.50	77.30	82.70	99.30	105.50	111.70	129.40
Prepaid Expenses	207.60	246.90	323.50	362.00	344.90	413.80	418.00	528.70
Total Current Assets	1,102.50	1,142.30	1,309.40	1,572.30	1,662.40	1,819.30	1,715.40	1,885.40
Net Plant, Prop., & Equip.	14,352.10	14,961.40	16,041.60	16,324.50	17,047.60	17,289.50	18,583.40	19,924.70
Intangibles	747.00	827.50	0.00	1,261.80	1,443.40	1,419.80	1,559.80	1,665.10
Other Non-Current Assets	1,184.40	1,310.30	2,433.40	1,824.60	1,530.10	2,005.90	2,111.90	2,049.90
Total Non-Current Assets	16,283.50	17,099.20	18,475.00	19,410.90	20,021.10	20,715.20	22,255.10	23,639.70
Total Assets	17,386.00	18,241.50	19,784.40	20,983.20	21,683.50	22,534.50	23,970.50	25,525.10
Liabilities & Equity	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Accounts Payable	638.00	650.60	621.30	585.70	684.90	689.50	635.80	577.40
Short-Term Debt	693.30	1,629.40	854.80	1,619.90	630.00	177.60	275.50	388.00
Accrued Liabilities	0.00	0.00	0.00	0.00	0.00	995.50	1,302.60	1,226.90
Other Current Liabilities	804.00	704.50	1,021.00	1,068.70	1,046.00	200.80	208.10	293.50
Total Current Liabilities	2,135.30	2,984.50	2,497.10	3,274.30	2,360.90	2,248.30	2,422.30	2,485.80
Long-Term Debt	4,830.10	4,834.10	6,188.60	5,632.40	7,843.90	8,555.50	9,703.60	9,342.50
Deferred Income Taxes	975.90	1,063.50	1,081.90	1,173.60	1,084.90	1,112.20	1,003.70	1,015.10
Other Non-Current Liabilities	0.00	507.80	552.10	1,263.80	1,189.40	1,130.10	560.00	699.80
Minority Interest	726.50	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total Non-Current Liabilities	6,532.50	6,405.40	7,822.60	8,069.80	10,118.20	10,797.80	11,267.30	11,057.40
Total Liabilities	8,667.80	9,389.90	10,319.70	11,344.10	12,479.10	13,046.10	13,689.60	13,543.20
Preferred Stock Equity	358.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Common Stock Equity	8,360.20	8,851.60	9,464.70	9,639.10	9,204.40	9,488.40	10,280.90	11,981.90
Common Par	0.00	0.00	0.00	16.60	16.60	16.60	16.60	16.60
Additional Paid In Capital	0.00	0.00	0.00	1,288.30	1,441.80	1,591.20	1,747.30	1,837.50
Retained Earnings	11,173.00	12,569.00	13,879.60	15,562.80	17,259.40	18,608.30	19,204.40	20,172.30
Treasury Stock	0.00	0.00	0.00	(6,208.50)	(8,111.10)	(8,912.20)	(8,987.70)	(9,318.50)
Other Equity Adjustments	0.00	0.00	0.00	(1,020.10)	(1,402.30)	(1,815.50)	(1,699.70)	(726.00)
Total Capitalization	0.00	0.00	0.00	15,271.50	17,048.30	18,043.90	19,984.50	21,324.40
Total Equity	8,718.20	8,851.60	9,464.70	9,639.10	9,204.40	9,488.40	10,280.90	11,981.90
Total Liabilities & Equity	17,386.00	18,241.50	19,784.40	20,983.20	21,683.50	22,534.50	23,970.50	25,525.10

McDonald's Corporation

Cash Flow Statement (1996–2003)

Operating Activities	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Net Income (Loss)	1,572.60	1,642.50	1,550.10	1,947.90	1,977.30	1,636.60	893.50	1,471.40
Depreciation	742.90	793.80	881.10	956.30	1,010.70	1,086.30	1,050.80	1,148.20
Deferred Income Taxes	32.90	(1.10)	35.40	52.90	60.50	(87.60)	(44.60)	181.40
Operating (Gains) Losses	0.00	0.00	0.00	0.00	0.00	0.00	98.60	36.80
Other Non-Cash Items	42.90	(65.90)	22.90	(65.10)	(244.10)	50.40	491.50	622.00
Changes in Working Capital								
(Increase) Decrease in Receivables	(77.50)	(57.60)	(29.90)	(81.90)	(67.20)	(104.70)	1.60	64.00
(Increase) Decrease in Inventories	(18.70)	(34.50)	(18.10)	(47.70)	(29.60)	(62.90)	(38.10)	(30.20)
(Increase) Decrease in Payables	44.50	52.80	(12.70)	(23.90)	89.70	10.20	(11.20)	(77.60)
(Increase) Decrease in Other Curr Liabs.	121.40	112.30	337.50	270.40	(45.80)	160.00	448.00	(147.20)
Net Cash from Operating Activities	2,461.00	2,442.30	2,766.30	3,008.90	2,751.50	2,688.30	2,890.10	3,268.80
Investing Activities	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Purch of Property, Plant, Equipment (PPE)	(2,513.00)	(2,224.80)	(1,997.70)	(2,208.50)	(2,370.60)	(2,237.80)	(2,552.20)	(1,683.20)
Sale of Property, Plant, Equipment	234.30	176.40	191.50	262.40	302.80	375.90	369.50	390.60
Other Investing Changes Net	(291.60)	(168.80)	(142.00)	(315.70)	(144.80)	(206.30)	(283.90)	(77.00)
Net Cash from Investing Activities	(2,570.30)	(2,217.20)	(1,948.20)	(2,261.80)	(2,212.60)	(2,068.20)	(2,466.60)	(1,369.60)
Financing Activities	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Issuance of Debt	1,620.60	2,135.30	1,461.50	1,019.20	2,440.40	1,694.70	1,502.60	398.10
Repayment of Long-Term Debt	(841.30)	(1,133.80)	(1,199.10)	(682.80)	(761.90)	(1,167.40)	(1,357.10)	(1,289.70)
Repurchase of Capital Stock	(599.90)	(1,113.10)	(1,089.80)	(891.50)	(2,023.40)	(1,068.10)	(670.20)	(391.00)
Payment of Cash Dividends	(232.00)	(247.70)	(240.50)	(264.70)	(280.70)	(287.70)	(297.40)	(503.50)
Other Financing Charges, Net	157.00	145.70	207.60	193.00	88.90	204.80	310.90	49.30
Net Cash from Financing Activities	104.40	(213.60)	(860.30)	(626.80)	(536.70)	(623.70)	(511.20)	(1,736.80)

Question:

If you had to create a headline for McDonald's 1996 to 2000 cash flow statement, what would it be?

Doing Your Homework: Advance Preparation for the 10Q Release

4. Take the 12-quarter rolling history of the income statement and balance sheet and convert to “common size”
 - “Common size” financial statements convert whole numbers to percentages to make relative comparisons possible.
 - Take each line item as a percent of Revenue on Income Statement – so that margins and costs as a percent of sales can be compared over time—a strong measure of operating efficiency, profitability, and the success of management strategies.
 - Take each line item as a percent of Assets on Balance Sheet—so that Assets and Debt Levels can be compared over time—a strong measure of ability to finance and asset utilization.
 - Compare current-year quarter to previous-year quarter – to eliminate seasonality effects.

McDonald's Corporation Common-Size Income Statement (1996-2003)

	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Total Revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Sales with Depreciation	38.2%	39.0%	39.0%	39.2%	48.0%	49.4%	49.8%	49.8%
Selling, Gen. & Administrative Expense	30.7%	30.5%	29.6%	29.4%	30.0%	30.7%	31.1%	30.6%
Income b/f Depreciation (EBITDA)	31.2%	30.6%	31.4%	31.5%	29.1%	27.2%	25.9%	26.3%
Depreciation	7.0%	7.0%	7.1%	7.2%	7.1%	7.3%	6.8%	6.7%
Operating Income after Deprec.	24.2%	23.6%	24.3%	24.2%	22.0%	19.9%	19.1%	19.6%
Earnings from Equity Interest	0.0%	0.0%	0.0%	0.0%	0.0%	0.4%	0.2%	0.2%
Other Income, Net	0.1%	0.7%	0.2%	0.6%	1.3%	-1.0%	-1.1%	-1.8%
Other Special Charges	0.0%	0.0%	0.0%	-0.1%	0.0%	-0.6%	-4.9%	-2.1%
Overall Operating Income (EBIT)	24.3%	24.3%	21.9%	24.7%	23.3%	18.7%	13.2%	16.0%
Interest Expense	3.2%	3.2%	3.3%	3.0%	3.0%	3.0%	2.4%	2.3%
Pre-Tax Income (EBT)	21.1%	21.1%	18.6%	21.8%	20.2%	15.7%	10.8%	13.7%
Income Taxes	6.3%	6.7%	6.1%	7.1%	6.4%	4.7%	4.3%	4.9%
Net Income from Total Operations	14.7%	14.4%	12.5%	14.7%	13.9%	11.0%	6.4%	8.8%
Inc. from Cum. Effect of Acct Chg	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	-0.6%	-0.2%
Total Net Income	14.7%	14.4%	12.5%	14.7%	13.9%	11.0%	5.8%	8.6%

McDonald's Corporation

Common-Size Balance Sheet (1996–2003)

Assets	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Cash and Equivalents	1.9%	1.9%	1.5%	2.0%	1.9%	1.9%	1.4%	1.9%
Accounts Receivable	2.8%	2.7%	3.1%	3.4%	3.7%	3.9%	3.6%	2.9%
Inventories	0.4%	0.4%	0.4%	0.4%	0.5%	0.5%	0.5%	0.5%
Prepaid Expenses	1.2%	1.4%	1.6%	1.7%	1.6%	1.8%	1.7%	2.1%
Total Current Assets	6.3%	6.3%	6.6%	7.5%	7.7%	8.1%	7.2%	7.4%
Net Plant, Prop., & Equip.	82.5%	82.0%	81.1%	77.8%	78.6%	76.7%	77.5%	78.1%
Intangibles	4.3%	4.5%	0.0%	6.0%	6.7%	6.3%	6.5%	6.5%
Other Non-Current Assets	6.8%	7.2%	12.3%	8.7%	7.1%	8.9%	8.8%	8.0%
Total Non-Current Assets	93.7%	93.7%	93.4%	92.5%	92.3%	91.9%	92.8%	92.6%
Total Assets	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Liabilities & Equity	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Accounts Payable	3.7%	3.6%	3.1%	2.8%	3.2%	3.1%	2.7%	2.3%
Short-Term Debt	4.0%	8.9%	4.3%	7.7%	2.9%	0.8%	1.1%	1.5%
Accrued Liabilities	0.0%	0.0%	0.0%	0.0%	0.0%	4.4%	5.4%	4.8%
Other Current Liabilities	4.6%	3.9%	5.2%	5.1%	4.8%	0.9%	0.9%	1.1%
Total Current Liabilities	12.3%	16.4%	12.6%	15.6%	10.9%	10.0%	10.1%	9.7%
Long-Term Debt	27.8%	26.5%	31.3%	26.8%	36.2%	38.0%	40.5%	36.6%
Deferred Income Taxes	5.6%	5.8%	5.5%	5.6%	5.0%	4.9%	4.2%	4.0%
Other Non-Current Liabilities	0.0%	2.8%	2.8%	6.0%	5.5%	5.0%	2.3%	2.7%
Minority Interest	4.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total Non-Current Liabilities	37.6%	35.1%	39.5%	38.5%	46.7%	47.9%	47.0%	43.3%
Total Liabilities	49.9%	51.5%	52.2%	54.1%	57.6%	57.9%	57.1%	53.1%
Preferred Stock Equity	2.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Common Stock Equity	48.1%	48.5%	47.8%	45.9%	42.4%	42.1%	42.9%	46.9%
Common Par	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%
Additional Paid In Capital	0.0%	0.0%	0.0%	6.1%	6.6%	7.1%	7.3%	7.2%
Retained Earnings	64.3%	68.9%	70.2%	74.2%	79.6%	82.6%	80.1%	79.0%
Treasury Stock	0.0%	0.0%	0.0%	-29.6%	-37.4%	-39.5%	-37.5%	-36.5%
Other Equity Adjustments	0.0%	0.0%	0.0%	-4.9%	-6.5%	-8.1%	-7.1%	-2.8%
Total Capitalization	0.0%	0.0%	0.0%	72.8%	78.6%	80.1%	83.4%	83.5%
Total Equity	50.1%	48.5%	47.8%	45.9%	42.4%	42.1%	42.9%	46.9%
Total Liabilities & Equity	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Key Conclusions from “Homework”

1. Profitability, Cash Flow have been concerns for last 5 years
 - Due to Lower Margins & Special Charges on Income Statement
 - Cash Flow from Operations not as strong due to increases in Accounts Receivable, Inventory
 - Historical Increases in Property, Plant, and Equipment (PPE)
2. News Peg → Profit Per Store might have declined as new investment in PP&E (new stores) has not provided the level of profits in the past—neither new McDonald’s stores nor the company’s other franchise brands.
3. Also, Debt Levels have increased consistently over last 5 years simultaneously as profit margins have declined.

What Does the Cash Flow Statement Really Tell You about Management?

1. Presents a cleaner picture of operations
 - Catches artificial and year-end extraordinary sales
 - Restructuring charges are converted to cash flows
 - Unlike net income, cash flows are generally real
2. Management actions: cash sources
 - Asset or business liquidation
 - Major debt issue
 - Stock issue
3. Management actions: cash uses
 - Internal growth
 - Acquisitions
 - Pay off debt or repurchase common stock
4. Bottom Line? Cash Flow Growth (NOT Earnings Per Share Growth) drives the Market Value of the Company (and eventually the Stock Price)... Earnings Per Share is just one “part of” the driving force – as “part of” Cash Flow

McDonald's Corporation

Cash Flow Statement (1996–2003)

Operating Activities	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Net Income (Loss)	1,572.60	1,642.50	1,550.10	1,947.90	1,977.30	1,636.60	893.50	1,471.40
Depreciation	742.90	793.80	881.10	956.30	1,010.70	1,086.30	1,050.80	1,148.20
Deferred Income Taxes	32.90	(1.10)	35.40	52.90	60.50	(87.60)	(44.60)	181.40
Operating (Gains) Losses	0.00	0.00	0.00	0.00	0.00	0.00	98.60	36.80
Other Non-Cash Items	42.90	(65.90)	22.90	(65.10)	(244.10)	50.40	491.50	622.00
Changes in Working Capital								
(Increase) Decrease in Receivables	(77.50)	(57.60)	(29.90)	(81.90)	(67.20)	(104.70)	1.60	64.00
(Increase) Decrease in Inventories	(18.70)	(34.50)	(18.10)	(47.70)	(29.60)	(62.90)	(38.10)	(30.20)
(Increase) Decrease in Payables	44.50	52.80	(12.70)	(23.90)	89.70	10.20	(11.20)	(77.60)
(Increase) Decrease in Other Curr Liabs.	121.40	112.30	337.50	270.40	(45.80)	160.00	448.00	(147.20)
Net Cash from Operating Activities	2,461.00	2,442.30	2,766.30	3,008.90	2,751.50	2,688.30	2,890.10	3,268.80
Investing Activities	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Purch of Property, Plant, Equipment (PPE)	(2,513.00)	(2,224.80)	(1,997.70)	(2,208.50)	(2,370.60)	(2,237.80)	(2,552.20)	(1,683.20)
Sale of Property, Plant, Equipment	234.30	176.40	191.50	262.40	302.80	375.90	369.50	390.60
Other Investing Changes Net	(291.60)	(168.80)	(142.00)	(315.70)	(144.80)	(206.30)	(283.90)	(77.00)
Net Cash from Investing Activities	(2,570.30)	(2,217.20)	(1,948.20)	(2,261.80)	(2,212.60)	(2,068.20)	(2,466.60)	(1,369.60)
Financing Activities	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Issuance of Debt	1,620.60	2,135.30	1,461.50	1,019.20	2,440.40	1,694.70	1,502.60	398.10
Repayment of Long-Term Debt	(841.30)	(1,133.80)	(1,199.10)	(682.80)	(761.90)	(1,167.40)	(1,357.10)	(1,289.70)
Repurchase of Capital Stock	(599.90)	(1,113.10)	(1,089.80)	(891.50)	(2,023.40)	(1,068.10)	(670.20)	(391.00)
Payment of Cash Dividends	(232.00)	(247.70)	(240.50)	(264.70)	(280.70)	(287.70)	(297.40)	(503.50)
Other Financing Charges, Net	157.00	145.70	207.60	193.00	88.90	204.80	310.90	49.30
Net Cash from Financing Activities	104.40	(213.60)	(860.30)	(626.80)	(536.70)	(623.70)	(511.20)	(1,736.80)

Key Metrics for Measuring Cash Flow and Cash Flow Growth

$$\begin{array}{r} \text{Net Income} \\ + \text{ Non-Cash Expenses} \\ - \text{ Non-Cash Revenues} \\ \hline \text{Net Cash Flow} \end{array}$$

$$\begin{array}{r} \text{Net Cash Flow} \\ +/- \text{ Change in Working Capital} \\ \hline \text{Cash Flow from Operations} \end{array}$$

$$\begin{array}{r} \text{Cash Flow from Operations} \\ - \text{ Purch of Prop, Plant, Equip} \\ \hline \text{Free Cash Flow} \end{array}$$

Key Metrics for Measuring Cash Flow and Cash Flow Growth

Net Income + Non-Cash Expenses - Non-Cash Revenues <hr/> Net Cash Flow	Net Cash Flow +/- Change in Working Capital <hr/> Cash Flow from Operations				Cash Flow from Operations - Purch of Prop, Plant, Equip <hr/> Free Cash Flow			
Cash Flow Metrics	Dec 1996	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Net Income	1,572.60	1,642.50	1,550.10	1,947.90	1,977.30	1,636.60	893.50	1,471.40
+/- Non-Cash Expenses / Revenue	818.70	726.80	939.40	944.10	827.10	1,049.10	1,596.30	1,988.40
Net Cash Flow	2,391.30	2,369.30	2,489.50	2,892.00	2,804.40	2,685.70	2,489.80	3,459.80
+/- Cash In (Out) from Working Capital	69.70	73.00	276.80	116.90	(52.90)	2.60	400.30	(191.00)
= Cash Flow From Operating Activities	2,461.00	2,442.30	2,766.30	3,008.90	2,751.50	2,688.30	2,890.10	3,268.80
Less: Purchase of PP & E	(2,513.00)	(2,224.80)	(1,997.70)	(2,208.50)	(2,370.60)	(2,237.80)	(2,552.20)	(1,683.20)
= Free Cash Flow	(52.00)	217.50	768.60	800.40	380.90	450.50	337.90	1,585.60

Question:

How do you make sure the company is reinvesting into its business and that the \$1.5 billion in free cash flow is not a one-time way of boosting cash flow?

Conclusions from Cash Flow Metrics

1. **Cash Flow from Operations declined through 2002** due to Net Income declining and higher cash outflows from Accounts Receivable and Inventory
2. **Free Cash Flow has also declined through 2002** as well as a result of declines from Cash Flow from Operations but also higher Purchases of Property, Plant, and Equipment
 - **Check why Purchase of Property, Plant, and Equipment lower than normal versus historical years.** Is it really because of better focus on specific store growth, or it is “under-investing” to artificially boost Free Cash Flow—“one time”?
3. **Both Cash Flow from Operations and Free Cash Flow have increased recently in 2003**, and it is likely as a result of the company’s focus on profitability per store, the “Plan to Win,” and the change in menu to Salads.

Process of Reading the 10Q Report*

1. Review the Key Points of McDonald's "News Peg."
 - In other words, keep in mind company's strategy of growing revenue per store, and thus, higher profit margins and same-store sales and cash flow
2. Enter Quarterly Financials into Spreadsheet and calculate Rolling 4-Quarter Average & Common-Size Statements. **For Income and Cash Flow Statements:**
 - **Do not worry about the 4-Quarter Average for Balance Sheet**, Accountants call this a "Stock Account," indicating "how much of a particular item" (not to be confused with shares)
 - What you have is what you have at any point in time. Review on a quarterly basis.

*Corrected slide

1st Quarter, 2004 Rolling Average Quarterly Income Statement

	Dec 2002	Mar 2003	Jun 2003	Sep 2003	Dec 2003	Mar 2004	L4Q 2003	L4Q 3-04
Total Revenues	15,405.70	3,799.70	4,280.80	4,504.60	4,555.40	4,399.70	17,140.50	17,740.50
Cost of Sales with Depreciation	7,668.50	2,732.70	2,975.00	3,076.60	3,159.40	3,073.80	11,943.70	12,284.80
Selling, Gen. & Administrative Expense	4,791.00	396.40	466.40	456.30	513.90	457.50	1,833.00	1,894.10
Income b/f Depreciation (EBITDA)	3,997.00	957.80	1,109.90	1,246.60	1,197.70	1,165.60	4,512.00	4,719.80
Depreciation	1,050.80	287.20	270.50	274.90	315.60	297.20	1,148.20	1,158.20
Operating Income After Deprec.	2,946.20	670.60	839.40	971.70	882.10	868.40	3,363.80	3,561.60
Earnings from Equity Interest	24.10	0.80	2.70	20.70	12.70	0.00	36.90	36.10
Other Income, Net	(172.90)	(40.40)	(44.60)	(87.00)	(141.20)	(18.90)	(313.20)	(291.70)
Other Special Charges	(761.20)	18.40	12.40	11.50	(395.40)	0.00	(353.10)	(371.50)
Overall Operating Income (EBIT)	2,036.20	649.40	809.90	916.90	358.20	849.50	2,734.40	2,934.50
Interest Expense	374.10	101.80	101.70	93.80	90.70	91.70	388.00	377.90
Pre-tax Income (EBT)	1,662.10	547.60	708.20	823.10	267.50	757.80	2,346.40	2,556.60
Income Taxes	670.00	183.40	237.30	275.70	141.80	246.30	838.20	901.10
Net Income from Total Operations	992.10	364.20	470.90	547.40	125.70	511.50	1,508.20	1,655.50
Inc. from Cum. Effect of Acct Chg	(98.60)	(36.80)	0.00	0.00	0.00	0.00	(36.80)	0.00
Total Net Income	893.50	327.40	470.90	547.40	125.70	511.50	1,471.40	1,655.50
Total Common Shares Outstanding	1,268.20	1,272.30	1,272.40	1,269.10	1,262.00	1,259.40	1,262.00	1,259.40
Treasury Shares	392.40	388.30	388.20	391.50	398.70	401.20	398.70	401.20

1st Quarter, 2004 Rolling Average Quarterly Common-Size Income Statement

	Dec 2002	Mar 2003	Jun 2003	Sep 2003	Dec 2003	Mar 2004	L4Q 12-03	L4Q 3-04
Total Revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Sales with Depreciation	49.8%	71.9%	69.5%	68.3%	69.4%	69.9%	69.7%	69.2%
Selling, Gen. & Administrative Expense	31.1%	10.4%	10.9%	10.1%	11.3%	10.4%	10.7%	10.7%
Income b/f Depreciation (EBITDA)	25.9%	25.2%	25.9%	27.7%	26.3%	26.5%	26.3%	26.6%
Depreciation	6.8%	7.6%	6.3%	6.1%	6.9%	6.8%	6.7%	6.5%
Operating Income After Deprec.	19.1%	17.6%	19.6%	21.6%	19.4%	19.7%	19.6%	20.1%
Earnings from Equity Interest	0.2%	0.0%	0.1%	0.5%	0.3%	0.0%	0.2%	0.2%
Other Income, Net	-1.1%	-1.1%	-1.0%	-1.9%	-3.1%	-0.4%	-1.8%	-1.6%
Other Special Charges	-4.9%	0.5%	0.3%	0.3%	-8.7%	0.0%	-2.1%	-2.1%
Overall Operating Income (EBIT)	13.2%	17.1%	18.9%	20.4%	7.9%	19.3%	16.0%	16.5%
Interest Expense	2.4%	2.7%	2.4%	2.1%	2.0%	2.1%	2.3%	2.1%
Pre-tax Income (EBT)	10.8%	14.4%	16.5%	18.3%	5.9%	17.2%	13.7%	14.4%
Income Taxes	4.3%	4.8%	5.5%	6.1%	3.1%	5.6%	4.9%	5.1%
Net Income from Total Operations	6.4%	9.6%	11.0%	12.2%	2.8%	11.6%	8.8%	9.3%
Inc. from Cum. Effect of Acct Chg	-0.6%	-1.0%	0.0%	0.0%	0.0%	0.0%	-0.2%	0.0%
Total Net Income	5.8%	8.6%	11.0%	12.2%	2.8%	11.6%	8.6%	9.3%

Process of Reading the 10Q Report*

3. Read the management discussion on what their quarter was like and track any changes associated with specific events (such as acquisitions / divestitures). For McDonald's, they include:
 - Store closings were taking place and charges were recorded closing out of store leases
 - Revenue growth came from new initiatives—McGriddle Breakfast Sandwiches, Premium Salads, Chicken McNuggets from White Meat, etc.
 - Salads Plus menu introduction drove growth in both domestic and international divisions
 - Strong sales drove margin expansion (more sales per store), but there continues to be commodity cost pressures for all food inputs, which is offsetting margins, but not completely.
Something to watch for future.

*Corrected slide

Process of Reading the 10Q Report*

4. Review Rolling Average of Cash Flow Statement.
 - To see key changes in specific line items as well as
 - Tracking Cash Flow Metrics, such as Cash Flow from Operations and Free Cash Flow

5. Read the Cash Flow and Financial Position Section of the 10Q.
For McDonalds:
 - Company reaffirms growth in cash flow—a good sign!
 - Capital expenditures reduced—aka slower store openings
 - Future capital expenditures to be \$1.5–1.6 billion compared with \$1.3 billion in 2003
 - Debt reduction and share buybacks a continued focus—a good sign as well!

*Corrected slide

1st Quarter, 2004 Rolling Average Quarterly Cash Flow Statement

(extracted)

Operating Activities	Dec 2002	Mar 2003	Jun 2003	Sep 2003	Dec 2003	Mar 2004	L4Q 12-03	L4Q 3-04
Net Income (Loss)	893.50	327.40	470.90	547.40	125.70	511.50	1,471.40	1,655.50
Depreciation	1,050.80	287.20	270.50	274.90	315.60	297.20	1,148.20	1,158.20
Deferred Income Taxes	(44.60)	34.60	0.00	131.80	15.00	(13.10)	181.40	133.70
Operating (Gains) Losses	98.60	n/a	n/a	n/a	n/a	n/a	36.80	0.00
Other Non-Cash Items	491.50	60.30	51.90	26.40	483.40	27.20	622.00	588.90
Changes in Working Capital	400.30	(157.40)	(107.40)	49.70	24.10	42.30	(191.00)	8.70
(Increase) Decrease in Receivables	1.60	n/a	n/a	n/a	n/a	n/a	64.00	n/a
(Increase) Decrease in Inventories	(38.10)	n/a	n/a	n/a	n/a	n/a	(30.20)	n/a
(Increase) Decrease in Payables	(11.20)	n/a	n/a	n/a	n/a	n/a	(77.60)	n/a
(Increase) Decrease in Other Curr Liabs.	448.00	n/a	n/a	n/a	n/a	n/a	(147.20)	n/a
Net Cash from Operating Activities	2,890.10	552.10	685.90	1,030.20	963.80	865.10	3,077.80	3,545.00
Investing Activities	Dec 2002	Mar 2003	Jun 2003	Sep 2003	Dec 2003	Mar 2004	L4Q 12-03	L4Q 3-04
Purch of Property, Plant, Equipment (PPE)	(2,552.20)	(304.20)	(316.30)	(257.50)	(805.20)	(180.30)	(1,683.20)	(1,559.30)
Sale of Property, Plant, Equipment	369.50	(21.80)	30.80	9.90	371.70	37.20	390.60	449.60
Other Investing Changes Net	(283.90)	(35.70)	6.60	(16.90)	(31.00)	(4.20)	(77.00)	(45.50)
Net Cash from Investing Activities	(2,466.60)	(361.70)	(278.90)	(264.50)	(464.50)	(147.30)	(1,369.60)	(1,155.20)
Financing Activities	Dec 2002	Mar 2003	Jun 2003	Sep 2003	Dec 2003	Mar 2004	L4Q 12-03	L4Q 3-04
Issuance of Debt	1,502.60	n/a	n/a	n/a	n/a	n/a	398.10	0.00
Repayment of Long Term Debt	(1,357.10)	(46.80)	(344.10)	(530.80)	(368.00)	(11.60)	(1,289.70)	(1,254.50)
Repurchase of Capital Stock	(670.20)	0.00	(26.00)	(139.50)	(225.50)	(291.50)	(391.00)	(682.50)
Payment of Cash Dividends	(297.40)	n/a	n/a	n/a	(503.50)	n/a	(503.50)	(503.50)
Other Financing Charges, Net	310.90	14.00	(4.50)	31.60	8.20	62.10	49.30	97.40
Net Cash from Financing Activities	(511.20)	(32.80)	(374.60)	(638.70)	(1,088.80)	(241.00)	(1,736.80)	(2,343.10)

1st Quarter, 2004 Rolling Average Quarterly Cash Flow Metrics

Cash Flow Metrics	Dec 2002	Mar 2003	Jun 2003	Sep 2003	Dec 2003	Mar 2004	L4Q 12-03	L4Q 3-04
Net Income	893.50	327.40	470.90	547.40	125.70	511.50	1,471.40	1,655.50
+/- Non-Cash Expenses / Revenue	1,596.30	382.10	322.40	433.10	814.00	311.30	1,988.40	1,880.80
Net Cash Flow	2,489.80	709.50	793.30	980.50	939.70	822.80	3,459.80	3,536.30
+/- Cash In (Out) from Working Capital	400.30	0.00	0.00	0.00	0.00	0.00	(191.00)	0.00
= Cash Flow From Operating Activities	2,890.10	709.50	793.30	980.50	939.70	822.80	3,268.80	3,536.30
Less: Purchase of PP & E	(2,552.20)	(304.20)	(316.30)	(257.50)	(805.20)	(180.30)	(1,683.20)	(1,559.30)
= Free Cash Flow	337.90	405.30	477.00	723.00	134.50	642.50	1,585.60	1,977.00

Key Questions for Senior Management

- What are the key metrics / targets that make up the “Plan to Win”?
- What menu changes are expected in addition to the Salads Plus to keep the Plan to Win strategy sustainable?
- What was the breakdown of sales by menu item to validate that the Salads Plus menu made the difference in volumes and margins? Was it the “Atkins Trend”?
- What are the average volumes of customers served per quarter / month for a typical McDonald’s store?
- Other?

Question:

Why do you use a common-size income statement and a common-size balance sheet while excluding the common-size cash flow statement?

Question:

Between changes in cash flow from operations and free cash flow, which is the most newsworthy?

Question:

You said net income is a deceptive number.
Could you elaborate?

Question:

How can someone find out if a company has made charitable contributions? Is that in the 10-Q?

Question:

How do you regard insider trades? Do you ever look at those?

Question:

What are some of your favorite footnotes to read?