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McDonald's, Wendy's, and Hedge Funds: Hamburger Hedging?

Hedge Fund Activism and Impact on Corporate Governance

Growing Hedge Fund Activism

Are hedge funds heroes or villains? Management of Blockbuster, Time Warner, Six Flags, Knight-Ridder, and Bally Total Fitness might prefer the “villain” appellation, but Enron, WorldCom, Tyco, and HealthSouth shareholders might view management as the real villains and hedge funds as vehicles to oust incompetent corporate managers before they run companies into the ground or steal them through fraudulent transactions. Could the pressure exerted by activist hedge funds on targeted companies result in increased share prices, management accountability, and better communication with shareholders? Or does it distract management from its primary goal of enhancing long-term shareholder value?

Hedge funds have been compared to the corporate raiders of the 1980s, who initiated hostile takeovers by using large amounts of debt to acquire target companies and then ousted management (and often thousands of employees as well). However, activist hedge funds typically use only their own equity to invest, without leveraging the target company, and generally work with existing management to effect change rather than dumping management and employees. And if hedge funds cannot engender support among the other major shareholders, they are usually forced to back down. Another difference between corporate raiders and hedge funds involves “greenmail”—forcing a company to buy out a large hostile shareholder at a premium price to escape unwanted attention. Raiders frequently initiate greenmail, but hedge funds never do.

Following corporate scandals at Enron and WorldCom, some observers believe activist hedge funds serve as catalysts for positive change at targeted underperforming companies. Even if hedge funds do not get everything they want, when they initiate an activist campaign target companies are frequently compelled to make changes that benefit all shareholders. Others think that, although hedge fund strategies may improve a company's share price in the short term, they may not always enhance the company's long-term viability. The evidence is mixed. Some studies suggest that target companies benefit from a more than 5 percent rise in share price after the campaign is initiated. Other studies propose that activism has little impact on share values and earnings in the long run. Only a small percentage of hedge fund assets are allocated to activist projects, but this activity is increasing and has been well publicized through proxy fights and “hostile 13-D” letters. When filed with the Securities and Exchange Commission (SEC), these letters become public vehicles for criticizing management in an effort to effect change (**Exhibit 1**).

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Assets under management by hedge funds exceeded \$1 trillion in 2005, almost 3 percent of global financial assets. More than 8,000 hedge funds and approximately 1,750 fund of hedge funds shared these assets. Because hedge funds have been particularly active stock traders, they have accounted for up to 50 percent of daily New York Stock Exchange trading volume. Hedge fund assets have grown at an annual rate of 26 percent since 1990, with approximately 40 percent of total assets concentrated in the top fifty hedge funds. High net worth investors represent nearly 75 percent of the asset base, but starting in 2001 more than 50 percent of the growth in this industry has come from institutional investors, with further “institutionalization” expected to provide most of the future growth. In February 2006 the hedge fund industry was required, for the first time, to register with the SEC (**Exhibit 2**).

A Tale of Two Activists: Carl Icahn and William Ackman

Well-known hedge fund activist Carl Icahn evolved from a feared corporate raider and greenmailer during the 1980s to a ubiquitous hedge fund manager with \$2.5 billion in assets and a personal net worth of \$8.5 billion. Icahn's image as a feared and disliked corporate raider has transformed in some quarters to a “white knight.” He has pushed through corporate change at Fairmont Hotels, Blockbuster, Kerr-McGee, Hollywood Entertainment, Siebel Systems, RiteAid, UnumProvident, and Time Warner. In late December 2005 he called Time Warner's sale of a 5 percent stake in its AOL division to Google a “disastrous decision,” making a potential AOL merger with other companies, such as eBay, Yahoo, or Microsoft, difficult.¹ Icahn said, “This joint venture is short-sighted in nature and may preclude any consideration of a broader set of alternatives that would better maximize value and ensure a bright future for AOL.”² In spite of these statements, he ultimately backed down from his threatened proxy battle to gain board seats as a prelude to breaking up the company, following Time Warner's agreement to boost its stock buyback effort and implement a \$1 billion cost reduction program. The most likely reason he aborted this effort was lack of support from other significant institutional investors.

Icahn's activism initiatives have principally focused on threatening or initiating proxy fights (asking shareholders to vote on key initiatives he has advocated), pushing companies to distribute more cash to shareholders through dividends and share repurchases, and reducing CEO compensation. In regard to proxies, Icahn has said, “We need to ensure we have the best minds possible focused on business issues, and shareholders cannot trust that corporations being advised by management consultants and investment bankers, neither of which are compensated based on the results they achieve for businesses over time, are going to come up with the best decisions for the company.”³ Concerning CEO compensation, he has argued, “CEO comp eats into earnings, creates a cycle of invisible dilution and further waste of cash through share buybacks at any level to prevent dilution, and perhaps worst of all, stratifies the company, making the CEO a demi-god in the organization for, basically, being highly paid.”⁴

Inherent in Icahn's activist behavior was the view that many corporations were sitting on too much cash. S&P 500 corporations held more than \$615 billion in cash at the end of 2005, the most in more than twenty-five years. This cash pile was equal to 40 percent of long-term debt,

¹ Verne Kopytoff, “Icahn Rips into AOL's \$1 Billion Google Deal,” *San Francisco Chronicle*, December 20, 2005.

² Ibid.

³ Deborah Solomon, “Fighting for a Fair Share,” *New York Times Magazine*, June 5, 2005.

⁴ Ibid.

which was also the highest percentage in twenty-five years. Icahn and other hedge fund activists wanted companies to pay out cash to shareholders through share repurchases (if the share price is weak) or through increased dividends. They also wanted companies to take on more risk by borrowing to increase leverage, creating pressure on management to become more efficient and accountable.

Another well-known activist, William Ackman, co-founded Gotham Partners in 1993 shortly after graduating from business school at the age of twenty-six. This fund, which made investments in both private equity and public markets, was liquidated nearly a decade later, before Ackman started Pershing Square Capital Management in early 2004. He launched Pershing with \$10 million of his own capital and \$50 million from a strategic investor. The Pershing fund was opened to new investors in early 2005, adding more than \$200 million to the prior base. With net returns of 42 percent in 2004 and 40 percent in 2005, funds under management exceeded \$1 billion from performance and additional investment in early 2006. Pershing took significant positions in both Sears and Kmart before their merger in the fall of 2004. It then drew substantial media attention in the latter half of 2005 after building equity positions through options in both McDonald's and Wendy's, prior to squaring off with each firm's management team regarding comprehensive restructuring and recapitalization plans. Ackman felt that neither company was managing its cash and other resources optimally, so he took large equity stakes believing he could then persuade management to make changes to enhance shareholder value. He explained, "It has become an environment in which boards of directors are more receptive as they are much more aware of potential for personal liability. Management is more willing to listen as mutual funds vote proxies for value-additive transactions and hedge funds are willing to take a much more active and influential role in corporate governance."⁵

Pershing Square's Initial Involvement: Wendy's and McDonald's

Wendy's

By mid-April 2005, Pershing Square had acquired nearly a 10 percent stake in Wendy's and encouraged the restaurant chain to spin off its Tim Hortons doughnut chain, enabling it to operate autonomously from Wendy's and to unlock shareholder value. At that point, Tim Hortons was Wendy's most significant growth driver, representing nearly 50 percent of overall operating profits. Many shareholders believed Wendy's stock price did not fully reflect the contribution of that unit until Pershing and others pressed for the spinoff. In his April 2005 earnings note, Lehman Brothers restaurant analyst Jeff Bernstein valued standalone Wendy's (excluding Tim Hortons) at a price/earnings (P/E) multiple of 14x, versus standalone Tim Hortons at a 24x P/E multiple. Wendy's stock rose 15 percent during the two-week period following Ackman's advocacy of a spinoff.

In mid-July Pershing submitted a detailed proposal to Wendy's management recommending not only the spinoff of Tim Hortons, but also the sale of a large portion of the company's restaurants to franchisees, a major share repurchase, and management avoidance of any large acquisitions. However, in spite of Ackman's 10 percent ownership of the company, Wendy's management refused to discuss these recommendations with him.

⁵ William Ackman, Pershing Square Capital Management, interview with the author, December 19, 2005.

In late July Wendy's announced it would sell 15 to 18 percent of Tim Hortons in a tax-free spinoff during the first quarter of 2006, and also disclosed authorization for an additional \$1 billion in stock repurchases, an increase in the company's dividend by 25 percent, the reduction of debt by \$100 million, and a program to sell more than two hundred real estate sites, close sixty poorly performing stores, and sell hundreds of company-owned restaurants (reducing company ownership levels from 22 percent to as low as 15 percent).

While Pershing's activism appeared to have accelerated management's initiatives, Wendy's stated in its late-July strategic initiative press release, "The board of directors and management began in 2004 a thorough review of the company's operations and strategic plan with its long-term, independent financial advisor, Goldman Sachs. The resulting initiatives announced today are a comprehensive approach to manage the company for the future."⁶ Despite this public statement, which ignored Ackman's efforts, many investors acknowledged that his vocal push motivated management to proactively restructure. From the initiation of Ackman's campaign for change at Wendy's starting in mid-April 2005 until early March 2006, Wendy's stock appreciated by 55 percent, from \$39 to nearly \$61.

McDonald's

At the end of 2005, McDonald's was one the few major restaurant chains that owned large amounts of real estate. Most restaurant chains principally used operating leases and off-balance-sheet financing to support their restaurant businesses and limit their actual real estate ownership. With thousands of well-positioned real estate properties, McDonald's carried a significantly higher property value on its balance sheet than any competitor. At the end of 2005 the real estate carrying value was approximately \$30 billion (property and equipment before accumulated depreciation and amortization), equal to almost two-thirds of the company's equity market value of \$45.6 billion. McDonald's 2005 year-end balance sheet is shown in **Exhibit 3**.

McDonald's had benefited from its 90 percent ownership in Chipotle, a Mexican restaurant that posted double-digit revenue growth from 1998 to 2005. However, even with a strong performance from this business, as of January 2006 McDonald's share price had not broken out of the low- to mid-\$30s price range that it had traded within since early 2001—well below its all-time high of \$48 in late 1999. In order to unlock the value of Chipotle from the relatively weaker value of the parent company, McDonald's decided to spin off 20 percent of the subsidiary through an IPO offering.

Since 2003 McDonald's had not increased or altered its long-term annual targets for system-wide sales and revenue growth of 3 to 5 percent, operating income growth of 6 to 7 percent, and return on invested capital in the high teens. This led to analyst commentary and McDonald's management discussions regarding a range of strategic options to improve the business. **Exhibit 4** through **Exhibit 7** show McDonald's historical performance and relative valuation.

In the late 1990s, when Ackman's Gotham Partners fund held a small stake in McDonald's, he researched the topic of spinning off restaurants and real estate. In late September 2005 Ackman resumed his focus on McDonald's by acquiring call options on 4.9 percent of the company's stock (approximately \$2 billion in value if options were exercised to acquire shares). After establishing this equity position, he met with McDonald's management and pushed for a

⁶ Wendy's press release, July 29, 2005.

recapitalization of the company. He indicated that the result of this recapitalization would be a share price increase of up to \$15 per share, nearly a 50 percent boost to the stock price at that time.

Ackman viewed McDonald's as three separate entities (highlighted in **Exhibit 8**):

1. Franchising operation: representing nearly 75 percent of the 32,000 McDonald's restaurants
2. Restaurant operation: company restaurant ownership of remaining 25 percent ("McOpCo")
3. Real estate business: land ownership of roughly 37 percent of all restaurants and 59 percent of all buildings

McDonald's franchising operation received fees equivalent to 4 percent of individual non-company-owned restaurant unit sales. The company's real estate business received annual rent payments of 9 to 10 percent, with higher rates outside the United States and in high-priced areas like New York City. Both franchise fees and rent payments provided stable cash flow, which amply supported the company's debt service requirements, share repurchase program, and capital improvement program.

Ackman's proposal to McDonald's recommended a large IPO of McOpCo (the company-owned restaurant operation), which historically underperformed the franchise system average returns by a nearly 2 percentage point margin.⁷ Pershing's full proposal⁸ included the following provisions:

- Step 1. Initiate an IPO of 65 percent of McOpCo—which owned about 8,000 restaurants—raising \$3.3 billion after taxes.
- Step 2. Issue nearly \$14.7 billion in debt secured against McDonald's real estate holdings.
- Step 3. Use the IPO proceeds and debt proceeds to:
 - a. Refinance the existing debt of "pro forma" McDonald's, a newly organized company operating as a real estate business ("Prop Co") and a restaurant franchise business ("Fran Co") (\$5 billion).
 - b. Repurchase 316 million shares at an estimated \$40 per share (\$12.6 billion).
 - c. Fund transaction costs and related fees (\$300 million).

Exhibit 9 through **Exhibit 13** provide more details regarding Ackman's full proposal to McDonald's.

McDonald's Management and Franchisees Respond

In late October 2005, after a Pershing team made its presentation to McDonald's management, Ackman had a follow-up meeting with the McDonald's board of directors. To help build his case, he cited precedent transactions and suggested that a restructuring would attract

⁷ Jeremy Grant, "Pershing Drops Push for McDonald's Shake-Up," *Financial Times*, January 25, 2006.

⁸ Pershing Square Capital Management, "Presentation: A Value Menu for McDonald's," November 2005.

new dividend/income-focused investors and real estate investors. Two independent investment banking advisors for McDonald's reviewed the Pershing proposal in regard to valuation and credit impact, and the McDonald's management team analyzed friction costs (property tax revaluations, legal, financing structure) and governance/alignment issues. Although McDonald's advisors agreed with most of Pershing's views on the McOpCo IPO valuation, they disagreed with the suggestion that a recapitalization would create a new pro forma entity that would trade at a higher P/E multiple.

In November McDonald's CFO rejected Pershing's suggestions, stating, "The proposal is an exercise in financial engineering and does not take into account McDonald's unique business model. While we remain open to ideas, we simply will not jeopardize the long-term health of our company, nor our relationships with customers, franchisees, and suppliers."⁹ Management also asserted that it was focusing on enhancing shareholder value by developing plans to sell more company-owned restaurants to franchisees in underperforming markets like the United Kingdom. McDonald's CEO reiterated that the company's "unmatchable" competitive advantage was its "three-legged stool": the company, its franchisees, and its suppliers. **Exhibit 14** highlights McDonald's rejection rationale.

A large franchisee group regarded Pershing's proposal as "injurious" to restaurant owners.¹⁰ The head of the national group of franchisees encouraged members to ignore Ackman's plan, stating in a letter distributed in late December, "While on the surface some of the ideas he is floating might seem to benefit us, we have serious concerns regarding the long-term impact of his approach and the unintended consequences that this might have for us and our system." McDonald's CFO characterized the plan as a "threat" to the company's relationship with franchisees that would lead to "unhealthy restaurant-level cash flow" and "loss of franchisee equity." McDonald's argued that franchisees were more comfortable knowing that corporate headquarters was not only a landlord but also a knowledgeable restaurant mentor.

Ackman believed that franchisees thought he wanted to sell the real estate their restaurants sat on, resulting in their having a new landlord. In fact, he wanted McDonald's to continue to be their landlord. Prior to unveiling a revised "franchisee-friendly" proposal, Ackman spoke with more than a dozen franchisees in an effort to earn their support to put more pressure on McDonald's management. He also suggested that dropping restrictions on the number of stores each franchisee could own would make franchisees more effective at running their stores because of economies of scale. Ackman pointed out that managers at company-owned stores lacked motivation without direct equity compensation, unlike franchisees. Finally, he reminded franchisees that a more profitable pricing structure would emerge as a result of reducing the number of company-owned stores because company stores did not have to pay 3 to 4 percent franchisee fees.

Rating Agency Concern

Credit rating agencies had significant concerns about Ackman's proposal. They felt that adding more debt to McDonald's in combination with a company-owned restaurant spinoff and a large share repurchase would result in ratings downgrades to just above high-yield/junk-bond status as a result of significant new debt service requirements. McDonald's had been rated

⁹ Bethany McLean, "Taking on McDonald's," *Fortune*, November 15, 2005.

¹⁰ Julie Jargon, "McD's, Ackman Lobby for Franchisee Backing," *Crain's Chicago Business*, December 1, 2005.

A/Stable by Standard and Poor's and A2 by Moody's since 2003 for senior unsecured debt. A Standard & Poor's rating agency director stated, "If McDonald's leveraged up their balance sheet to do a share repurchase, their credit rating would be under great pressure. The lower the credit rating, the higher their interest rate becomes and the more expensive it becomes to finance expansion."¹¹ Many analysts believed that the massive amount of incremental debt recommended by Ackman's initial proposal would seriously erode earnings. An estimated 20 cents from every dollar operating profit would be used to service debt, leaving the company with less cash to invest in existing stores and for expansion.¹²

Unlocking McDonald's Real Estate Value

The Pershing team valued McDonald's total real estate, including leaseholds, at \$46 billion, substantially higher than its recorded book value of \$30 billion (\$20 billion after depreciation and amortization). The \$46 billion valuation was nearly equal to the company's enterprise value of \$52 billion (\$46 billion market capitalization at that time plus \$6 billion net debt). This implied a substantial disconnect between how investors viewed McDonald's and how Ackman viewed it. The question was whether the market was ignoring most of the company's real estate value and even its brand value by focusing instead principally on earnings.

Vornado Realty Trust, which owned nearly 90 million square feet of office and retail space principally in the Northeast, had purchased a 4.3 percent stake in Sears prior to its merger with Kmart and had acquired a more-than-30 percent stake in Toys "R" Us at the time of its buyout. Both of these acquisitions were premised on the assumption that the equity market was undervaluing the real estate component of these retailers. In an early November 2005 filing with the SEC, Vornado indicated that it had acquired a 1.2 percent stake in McDonald's during the third quarter of 2005 and implied that it viewed that company's real estate undervalued. Vornado had used a combination of puts and calls to obtain its stake, transacted exclusively through private negotiations during the third quarter of 2005. It asserted that, although McDonald's carried \$30 billion of real estate on its books, the true worth was not being adequately recognized by the market at current terms.¹³ A popular and simple method of valuing real estate is to apply a capitalization rate (cap rate) to the net operating income of the property. While cap rates vary by market, property type (residential, commercial, industrial, etc.), and economic conditions, analysts believed a 7 percent cap rate was appropriate for McDonald's real estate portfolio. Using this cap rate resulted in a McDonald's total real estate value (land, buildings, and leaseholds) of nearly \$64 billion prior to subtracting net rent (**Exhibit 15**).¹⁴ Although Vornado did not disclose its exact valuation view, it might not have been very different from this level.

Vornado was focused on transferring all or most of McDonald's real estate assets into an REIT (real estate investment trust), which would be required to distribute almost all unpaid earnings and profits tied to real estate. Deutsche Bank estimated that an REIT distribution would be equal to \$20 billion pre-tax—or a nearly-\$16-per-share payout after taxes (equal to 45 percent of McDonald's stock price in February 2006). An REIT is a publicly traded trust or corporation that pools capital from investors to buy or manage income properties and mortgages. REITs tend

¹¹ Julie Jargon, "Ackman 101: Debt Could Squeeze Growth at McDonald's," *Crain's Chicago Business*, December 12, 2005.

¹² Ibid.

¹³ Nicholas Yulico, "McDonald's REIT Could Be a Sizzler," *TheStreet.com, Inc.*, November 9, 2005.

¹⁴ Ibid. (Lou Taylor, Deutsche Bank equity research analyst.)

to trade with valuations reflecting broader market conditions and act as a liquid means of investing in real estate. They are generally not taxed on income, provided their dividend payout is at least 90 percent of taxable income and certain other provisions are also met. While a \$20 billion special REIT dividend would attract attention and strong investor interest, a popular criticism of this new REIT formation was the likelihood of its involving significant costs from transfer taxes, property tax reassessment expenses, and capital gains taxes on particular properties. Moreover, loss of control and the future value of lease renewals tend to be top concerns for REIT transfers.

There were distinct differences in the proposals offered by Pershing and Vornado. Pershing argued that, since McDonald's company-operated restaurant business was very capital intensive and yielded low margins, part of McOpCo should be sold through an IPO. However, Pershing would keep all of McDonald's real estate and use it as a vehicle for issuing collateralized debt to fund a large share repurchase. Vornado, on the other hand, was focused on spinning off McDonald's real estate assets into an REIT and did not advocate either an IPO of McOpCo or a share repurchase.

Aftermath of McDonald's Rejection

In the week following management's rejection of Ackman's proposal, Pershing hosted a conference in November 2005 for McDonald's shareholders to discuss potential options for McDonald's. In his presentation, Ackman praised McDonald's management for its strong operational execution over the past two years, but indicated that the company should be doing more for its shareholders, maintaining pressure for change.

Lehman Brothers restaurant analyst Jeff Bernstein later explained, "Hedge funds were happy with Pershing's proposal to Wendy's and have reaped the benefits. Long-term holders are mixed about the impact, yet Wendy's stock was not doing well, so many should have been happy with the price appreciation. It made Wendy's further consider whatever they had previously contemplated. McDonald's has adopted and will continue to adopt certain aspects of Ackman's proposal. However, some of McDonald's stockholders are saying that Pershing and others should stop pressuring management since fundamentals are strong."¹⁵

In mid-January 2006, three months after his original proposal and two months after its rejection, and after speaking to more than a third of McDonald's largest investors, Ackman revised his plan based on the following key points:

- Sell off 20 percent of McOpCo, the company-operated franchises, in an IPO instead of the previous 65 percent target (tax-free benefit if stake sold is 20 percent or lower)
- Use the IPO funds along with existing cash balances to boost expansion of restaurants in China and Russia
- Triple the current dividend to \$2, retire all unsecured debt, and repurchase more shares than currently targeted by the company

¹⁵ Jeff Bernstein, Lehman Brothers restaurant equity research analyst, interview with the author, December 21, 2005.

- Refranchise 1,000 stores in mature markets over the next two to three years (retire lower-performing franchisees and start new ones in replacement)
- Provide more disclosure around financial performance of company-owned stores

Basically, Ackman dropped the two most controversial parts of his previous proposal (\$12.6 billion in share repurchases and \$14.7 billion in new debt issuance backed by real estate), while reducing the percentage of the McOpCo IPO and increasing the company's dividend.

McDonald's quickly rejected Ackman's second proposal, asserting there was nothing "fundamentally new" about it. Ackman responded, "If something is not done to boost McDonald's share price, it could become the target of a leveraged buyout. With \$50 billion in leverageable real estate and a robust commercial mortgage-backed securities market, McDonald's is going to be bought if it languishes at \$30 per share."¹⁶ He remained resolute in pushing for a McOpCo IPO to create a separate restaurant operating company, indicating that this would result in greater transparency and efficiency, and an expansion in the company's P/E multiple. **Exhibit 16** highlights quotes and outside criticisms relating to hedge fund activism and Pershing Square's McDonald's proposal.

The Truce

During a year-end earnings conference call in late January 2006, McDonald's CEO said, "The system is a bastion of credibility for a company that is, at its core, a franchising operation. Abandoning it or restructuring it—as hedge-fund activist William Ackman has proposed recently—is out of the question." However, notwithstanding this strong statement, the CEO announced that McDonald's would shift some underperforming stores to more profit-focused owners by selling nearly 1,500 company-owned stores in fifteen to twenty countries to "development license ownership" over the next three years, including 800 stores in the United Kingdom. The CEO also committed to providing better information comparing the performance of company-operated restaurants and franchised restaurants. The day following McDonald's agreement to sell underperforming company-owned restaurants and to provide better financial transparency, Ackman dropped his activist campaign, stating, "We are supporting McDonald's because they're doing the right thing. They've pretty much given us everything we wanted. The only thing we didn't get, which we felt would have given more instant value, would've been a true separation for McOpCo" (the IPO).¹⁷ **Exhibit 17** contrasts the cash payout differences between Pershing's two proposals and McDonald's management's final decision.

Retrospective

In November 2005, when asked about the likelihood of Pershing's proposal actually being executed by McDonald's, Ackman responded, "I'm the most persistent person, especially when I believe I'm right. I don't think this will have to be taken to a proxy contest. It's an intellectual contest. We have the ability to share our ideas." Pershing's option on up to 4.9 percent of the

¹⁶ Christine Richard, "Pershing Sq Scraps Debt Issuance in McDonald's Plan," *Dow Jones Newswires*, January 18, 2006.

¹⁷ Nicholas Yulico, "McDonald's Placates Pershing," *TheStreet.com, Inc.*, January 25, 2006.

company's stock represented the second largest shareholding in McDonald's after Dodge & Cox at 5.5 percent. The top ten stakeholders combined, excluding Pershing, accounted for 30 percent of outstanding shares. Vornado and Pershing combined represented slightly more than 6 percent of shares; however, their full level of backing by other investors, whether hedge or mutual funds, was not publicly determinable.

In December Ackman explained, "If businesses are undervalued and if there are simple things to do, the shareholder base becomes more perceptive. McDonald's had done nothing in five years and Wendy's had not done much prior to the summer. We convinced Wendy's to restructure and the stock is up \$17 in the last few months since Pershing stepped in. McDonald's management was more willing to discuss our thoughts and we will see how that turns out."

Ackman went on, "We do our homework to find a deep discount between price paid and actual value. Our approach is to talk to management first without going public." Pershing considered only public companies because Ackman believed it took different skill sets to invest in private and public companies. He added, "Pershing focuses on high-quality businesses, and so if you are wrong on timing, you can still make up for it on attractive quality as the company becomes more valuable with each day that passes." Wendy's stock was up 55 percent since Pershing first established its equity position; however, McDonald's stock was up only 20 percent. Ackman still believed that his original transformational strategic plan for McDonald's would push the share price to \$45–50 per share, a 37 to 52 percent premium to the stock price at the time of his initial proposal.

Separately, two of the most anticipated IPOs of early 2006 included Chipotle (McDonald's stake) and Tim Hortons (Wendy's stake). The Chipotle IPO broke the five-year largest opening day gain record when it was launched during January 2006, doubling on the first day of the offering, and Tim Hortons IPO traded up 42 percent during its opening day in late March 2006.

Exhibit 1: 13-D Letters as a Public Vehicle

SEC Regulation 13-D requires every investor who acquires a beneficial ownership of more than 5 percent of a publicly traded security to file a holdings report with the SEC. The filing includes information on the investor's background and future plans. Since it warns of a changing shareholder base, it allows the target company to initiate potential defensive actions such as share repurchases, preferential share reallocations (poison pills), and announcements of strategic changes, acquisitions, and debt-loading if the target is concerned about a hostile action.

13-D filings and attached letters can also become a public vehicle for criticizing management. For example, Daniel Loeb, a hedge fund activist who managed a \$3.5 billion fund called Third Point, was known for being rather blunt and abrupt in his 13-D filings and statements to management, earning him the nickname "Wall Street's Merchant of Venom."¹⁸ In a 13-D letter to Star Gas's CEO, Loeb stated, "Do what you do best: Retreat to your waterfront mansion in the Hamptons."¹⁹ To another CEO, Loeb stated, "I also have excellent news, which I would like to share with you and the board: After significant reflection regarding the time commitments and constraints that such a responsibility would entail, I have decided to volunteer to serve on the company's board of directors"²⁰ He told yet another CEO, "Since you ascended to your current role of Chief Value Destroyer, the shares have dropped over 45 percent"²¹

Exhibit 2: SEC Hedge Fund Regulation

Historically, hedge funds were not required to register with the SEC and had minimal regulatory oversight. However, in February 2006 the SEC required hedge funds to register in an effort to deter or detect fraud at early stages. During 2005 the SEC had taken action against twenty hedge funds, a significant increase over previous years, with the most common violation related to misrepresentation of management experience and investment performance track record. On its Web site, the SEC advises investors to seek out a hedge fund's prospectus, valuation methodology of the fund's assets, impact on returns from both management and performance fees, limitations on redemption of shares (timing/lock-ups), management background, and asset allocation.

¹⁸ Nichola Groom, "McDonald's Investors Unswayed by Activist Proposal," *Reuters*, January 19, 2006.

¹⁹ James Altucher, "Activist Track: The Softer Side of Loeb," *TheStreet.com, Inc.*, August 23, 2005.

²⁰ *Ibid.*

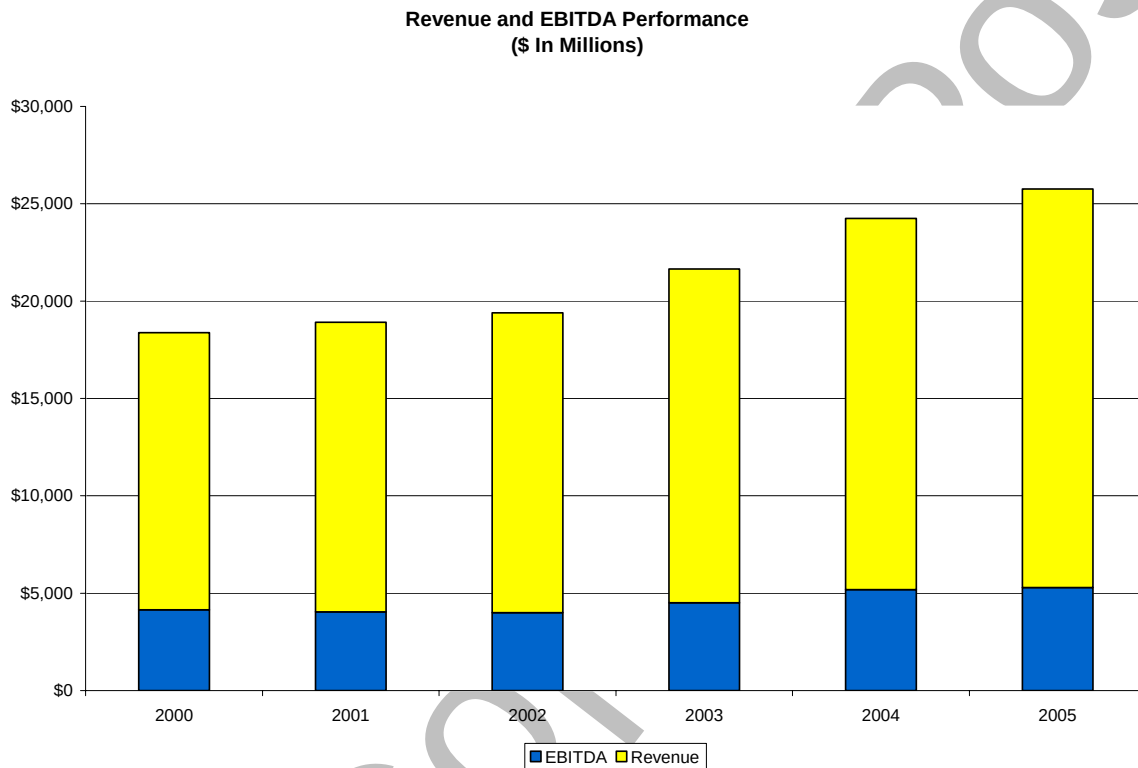
²¹ *Ibid.*

Exhibit 3: McDonald's Balance Sheet, 2005

	December 31	
	2005	2004
ASSETS		
<i>Current assets</i>		
Cash and equivalents	\$ 4,260.40	\$ 1,379.80
Accounts and notes receivable	795.90	745.50
Inventories, at cost, not in excess of market	147.00	147.50
Prepaid expenses and other current assets	646.40	585.00
Total current assets	5,849.70	2,857.80
<i>Other assets</i>		
Investments in and advances to affiliates	1,035.40	1,109.90
Goodwill, net	1,950.70	1,828.30
Miscellaneous	1,245.00	1,338.40
Total other assets	4,231.10	4,276.60
<i>Property and equipment</i>		
Property and equipment, at cost	29,897.20	30,507.80
Accumulated depreciation and amortization	(9,989.20)	(9,804.70)
Net property and equipment	19,908.00	20,703.10
Total assets	29,988.80	27,837.50
LIABILITIES AND SHAREHOLDERS' EQUITY		
<i>Current liabilities</i>		
Notes payable	544.00	—
Accounts payable	689.40	714.30
Income taxes	567.60	331.30
Other taxes	233.50	245.10
Accrued interest	158.50	179.40
Accrued payroll and other liabilities	1,184.60	1,188.20
Current maturities of long-term debt	658.70	862.20
Total current liabilities	4,036.30	3,520.50
Long-term debt	8,937.40	8,357.30
Other long-term liabilities	892.30	976.70
Deferred income taxes	976.70	781.50
Shareholders' equity		
Preferred stock, no par value; authorized—165.0 million shares; issued—none		
Common stock, \$0.01 par value; authorized—3.5 billion shares; issued—1,660.6 million shares	16.60	16.60
Additional paid-in capital	2,797.60	2,186.00
Unearned ESOP compensation	(77.40)	(82.80)
Retained earnings	23,516.00	21,755.80
Accumulated other comprehensive income (loss)	(733.10)	(96.00)
Common stock in treasury, at cost; 397.4 and 390.7 million shares	(10,373.60)	(9,578.10)
Total shareholders' equity	15,146.10	14,201.50
Total liabilities and shareholders' equity	29,988.80	27,837.50

Note: Dollars in millions, except per share data.

Source: McDonald's Corporation 10-K Filing.

Exhibit 4: McDonald's Historical Revenue and EBITDA Performance

	2000	2001	2002	2003	2004	2005
Same-store sales	0.6%	-1.3%	-2.1%	2.4%	6.9%	3.9%
EBITDA margin	29.0%	27.0%	26.0%	26.0%	27.0%	26.0%

Note: 2005 EBITDA is an estimate because 2005 10-K had not been filed with depreciation and amortization results as of the writing of this case.

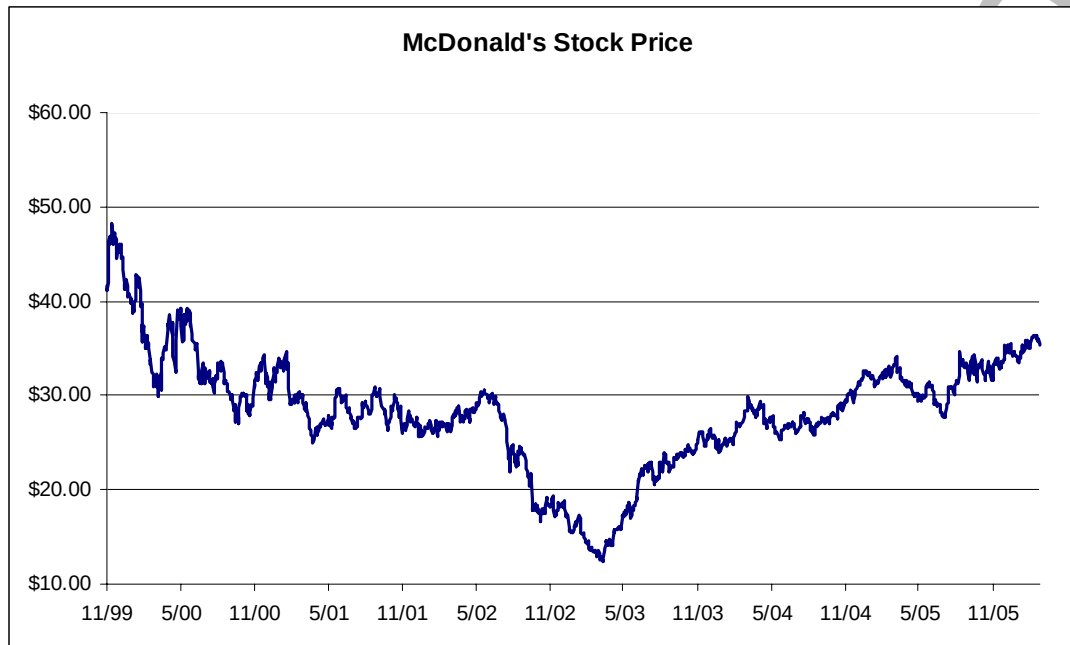
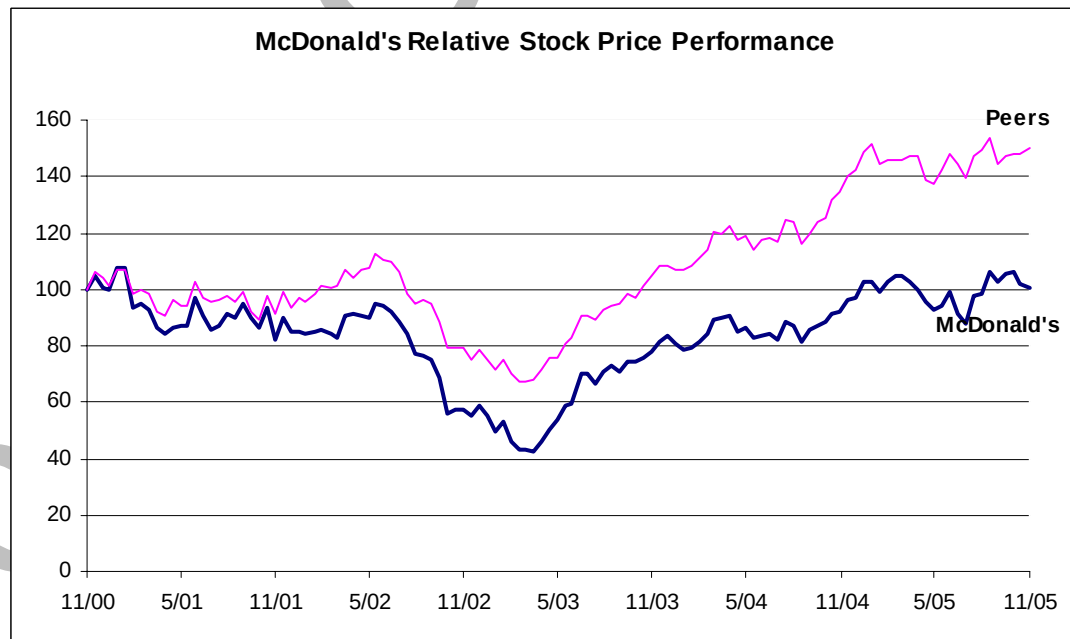
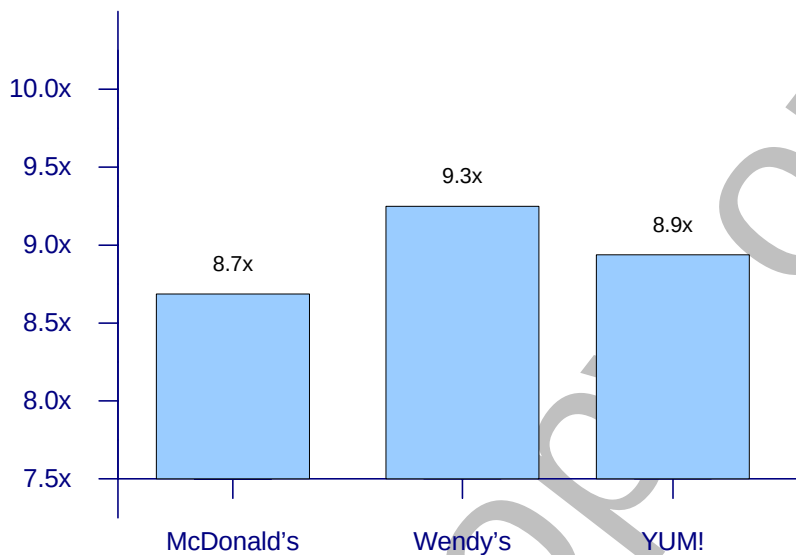
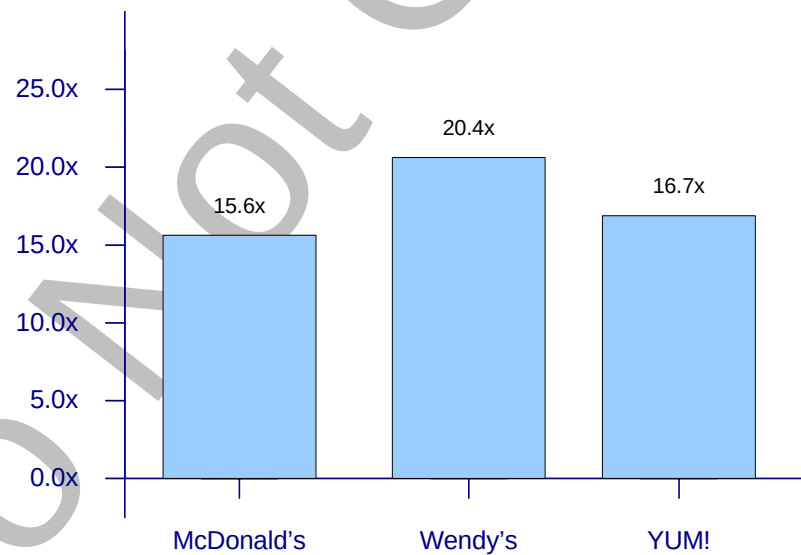
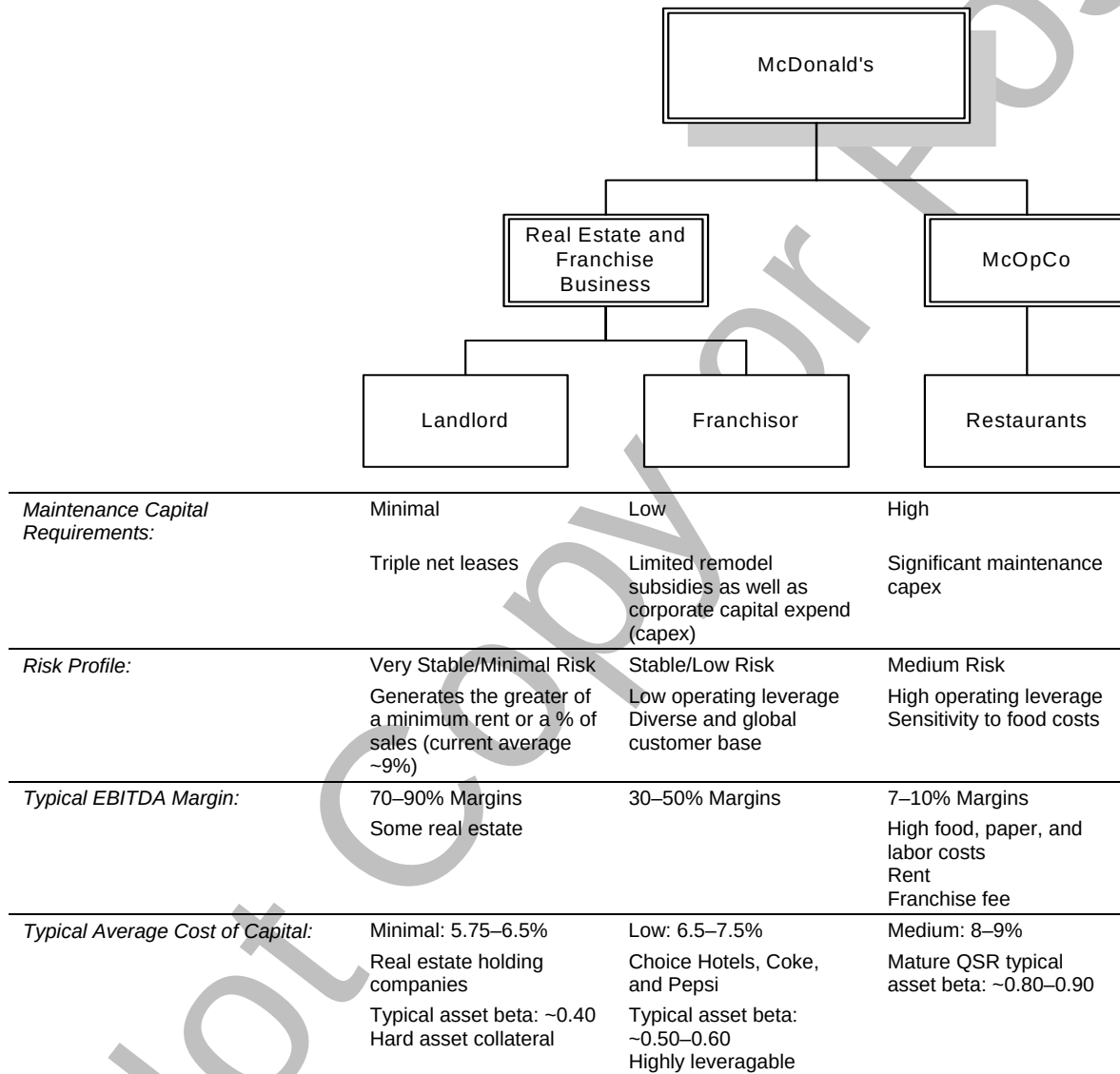
Exhibit 5: McDonald's Stock Price Performance Since All-Time High in November 1999**Exhibit 6:** McDonald's Five-Year Relative Stock Price Performance vs. Peers

Exhibit 7: McDonald's Relative Valuation

Despite McDonald's strong real estate outlets, number-one market share position in the industry, and leading brand, McDonald's traded at a discount to peers (November 2005).

EV/EBITDA (2006 Estimates in November 2005)**P/E (2006 Estimates in November 2005)**

Source: Pershing Square Capital Management, "Presentation: A Value Menu for McDonald's," November 2005.

Exhibit 8: Pershing's View of McDonald's as Three Separate Entities

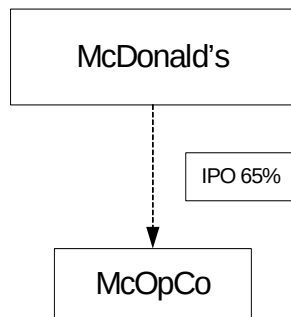
Notes: Typical margins are illustrative of restaurant EBITDA margins and assume the payment of a market rent and franchisee fee similar to a franchisee.

Typical betas are Pershing approximations based on selected companies' Barra predictive betas. Average cost of capital estimates are illustrative estimates based on average asset betas.

Source: Pershing Square Presentation, November 2005.

Exhibit 9: McOpCo IPO Process**STEP 1: IPO OF 65% MCOPCO**

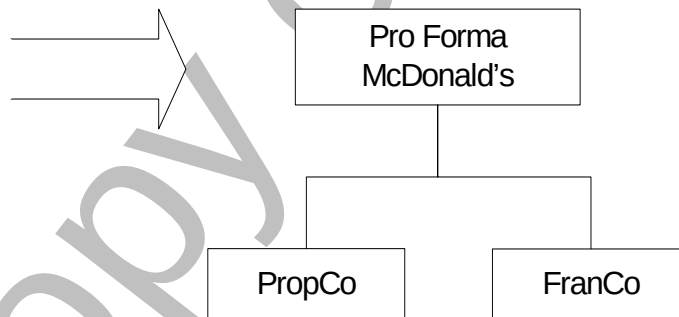
- IPO 65% of McOpCo
- IPO generates estimated \$3.27 billion of after-tax proceeds
 - Assumes a 7x EV/FY 2006E EBITDA multiple
 - Assumes \$1.35 billion of net debt allocated to McOpCo



- At the time of IPO, McOpCo signs market lease and franchise agreements with PF McDonald's

STEP 2: ISSUE DEBT AND PURSUE LEVERAGED SELF-TENDER

- Issue \$14.7 billion of financing secured against pro forma McDonald's ("PF McDonald's") real estate
- Debt financing and IPO proceeds used to:
 - Refinance all of the existing \$5 billion of net debt at PF McDonald's
 - Repurchase 316 million shares at \$40 per share
 - Pay \$300 million in fees and transaction costs



- Resulting PF McDonald's is a world-class real estate and franchise business
 - McOpCo financials deconsolidated from PF McDonald's
- Leverage is placed only on PropCo
- FranCo is unlevered, maximizing its credit rating

Source: Pershing Square Presentation, November 2005.

Exhibit 10: Transaction Transformation Estimates*Improves Operating and Financial Metrics at Every Level*

- Significantly improves PF McDonald's EBITDA and free cash flow margins
- Enhances return on capital and overall capital allocation for PF McDonald's
- Improves ability of PF McDonald's to pay significant ongoing dividends

	McDonald's Standalone FY 2006E	Pro Forma McDonald's FY 2006E	Typical Mature QSR
Revenue	\$20,816	\$7,393	
EBITDA	5,594	4,464	
<i>EBITDA margin</i>	26.9%	60.4%	15–20%
EBITDA—Capex	4,335	3,739	
<i>EBITDA—Capex margin</i>	20.8%	50.6%	7.5–12.5%
EBITDA—Maintenance capex	4,651	4,025	
<i>EBITDA—Maintenance capex margin</i>	22.3%	54.4%	10–15%
FCF	3,059	2,440	
<i>FCF margin</i>	14.7%	33.0%	5–10%

Note: Capex projections are net of proceeds obtained from store closures. Dollars in millions.

Source: Pershing Square Presentation, November 2005.

Exhibit 11: Comparable Companies

PF McDonald's operating metrics are much closer to those of a typical real estate C corporation or a high-branded intellectual property business such as PepsiCo or Coca-Cola than they are of a typical QSR.

	High-Branded Intangible Property					Typical Mature QSR ^a
	Pro Forma McDonald's	Typical Real Estate C Corp	Choice Hotels	PepsiCo	Coca-Cola	
2005E operating metrics:						
EBITDA margins	60%	~70–80%	66%	23%	31%	~15–20%
EBITDA—Capex margins	50%	~65–75%	61%	18%	27%	~7.5–12.5%
EPS growth	9%	NA	16%	11%	9%	~10–12%
Trading multiples:						
Adjusted enterprise value ^b						
CY 2006E EBITDA	13.0x	~13x–16x	15.1x	12.3x	12.6x	~8.5x–9.5x
CY 2006E EBITDA—Capex	15.5x	~17x–20x	16.0x	15.5x	14.2x	~12x–15x
Price						
CY 2006E EPS	21.1x	NA	24.3x	20.1x	18.8x	~15x–19x
CY 2006E FCF ^c	20.9x	~20x–25x	24.0x	20.8x	18.9x	~16x–20x
Leverage multiples:						
Net debt/EBITDA	3.4x	~5x–10x	1.7x	0.0x	NM	~0.5x–1.8x
Total debt/enterprise value	24%	~35–60%	11%	4%	4%	~7.5–20%

^a Typical mature QSR based on YUM! Brands and Wendy's.

^b Adjusted for unconsolidated assets.

^c FCF denotes net income plus D&A less capex.

Notes: Stock prices as of 11/11/2005. Projections based on Wall Street estimates. Assumes PF McDonald's price of ~\$47.50.

Exhibit 12A: McOpCo Valuation Summary and Potential IPO Proceeds

McOpCo would likely be valued at \$6.0–\$7.1 billion of equity market value or 6.5x–7.5x EV/2006E EBITDA.

McOpCo Financial Summary	FY 2006E	McOpCo Valuation Summary	Low	High
Company-operated revenues	\$15,429	EV/2006E EBITDA multiple range	6.5x	7.5x
Segment EBITDA, pre-G&A	1,690	McOpCo enterprise value	\$7,343	\$8,472
EBITDA margin, pre-G&A	11.0%	Net debt (12/31/05)	1,350	1,350
Assumed G&A for McOpCo	560	Equity value of McOpCo	\$5,993	\$7,122
Assumed G&A as % of total G&A	25.0%	Ending shares outstanding	1,274	1,274
EBITDA post-G&A	\$1,130	Price per share	\$4.70	\$5.59
EBITDA margins	7.3%	Estimated after-tax IPO proceeds	\$3,042	\$3,497
Net income	\$308			
EPS	\$0.24			

Source: Pershing Square Presentation, November 2005.

Note: Dollars in millions, except per share data.

Exhibit 12B: PF McDonald's Valuation Summary

Based on relevant publicly traded comparable companies, including several real estate holding C corporations, PF McDonald's should trade in the range of 12.5x–13.5x EV/CY 2006E. This implies a 37 to 52 percent premium over the recent stock price of \$33.

PF McDonald's Summary Financials	FY 2006E	PF McDonald's Valuation	Low	High
Franchise revenue	\$2,275	EV/2006E EBITDA multiple range	12.5x	13.5x
Real estate revenue	5,118	Enterprise value	\$55,799	\$60,263
Total revenue	\$7,393	Less: Net debt (12/31/05E) ^a	14,650	14,650
		Plus: Remaining stake in McOpCo ^b	2,097	2,493
Franchise EBITDA, pre-G&A	\$2,275	Equity value	\$43,247	\$48,106
Real estate EBITDA, pre-G&A	3,869	Ending shares outstanding (12/31/05E) ^c	957.3	957.3
Less: Allocated G&A	1,680	Price per share	\$45	\$50
Assumed G&A as % of total G&A	75.0%	Premium to recent price ^d	36.9%	52.3%
Total EBITDA	\$4,464	Implied P/FY 2006 EPS multiple	19.9x	22.2x
EBITDA margins	60.4%	Implied P/FY 2006 FCF multiple ^e	19.8x	21.9x
		Implied FCF/dividend yield	5.1%	4.6%
Net income	2,141	Memo: share buyback:		
EPS	\$2.27	Incremental debt issued		\$9,685
		Less transaction fees and expenses ^f		(\$300)
		Approximate cash received from IPO, after tax		\$3,270
		Total funds available for repurchase		\$12,654
		# of shares repurchased (in millions)		316
		Average price of stock purchased		\$40

^a Assumes \$1.35 billion of net debt allocated to McOpCo and \$5.0 billion of net debt allocated to PF McDonald's. In addition, assumes \$9.7 billion of incremental leverage placed on PF McDonald's.

^b Represents 35% of market equity value of McOpCo.

^c Assumes incremental leverage and after-tax proceeds from McOpCo IPO (net of fees and expenses) are used to buy back approximately 316 million shares at an average price of \$40.

^d Assumes recent stock price of \$33.

^e P/FY 2006E FCF multiple adjusted for PF McDonald's 35% stake in McOpCo.

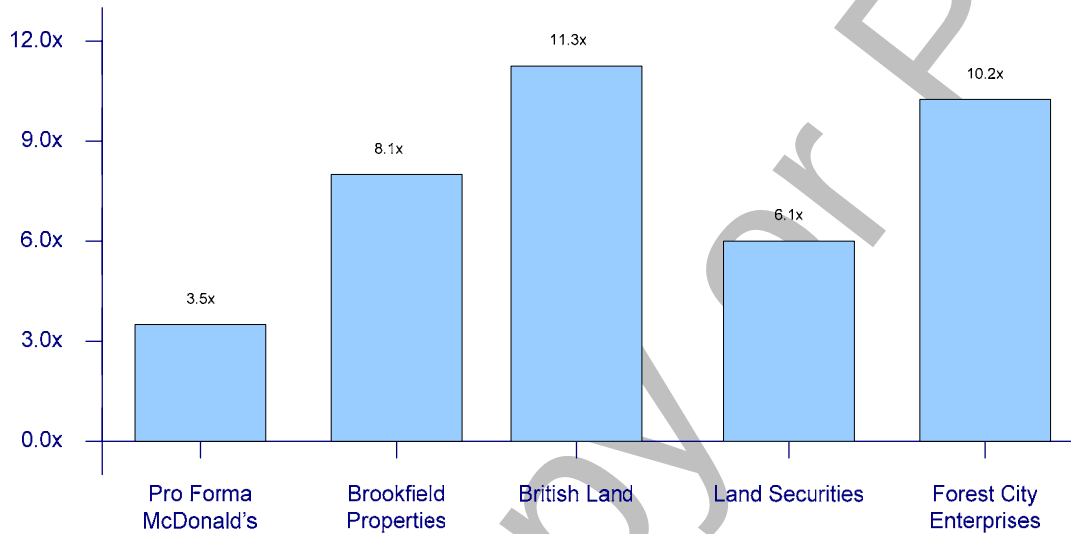
^f Fees and expenses associated with the IPO and financing transactions.

Source: Pershing Square Presentation, November 2005.

Note: Dollars in millions, except per share data.

Exhibit 13: Comparison of Pro Forma McDonald's with Real Estate Holding Corporations

Total Debt/2005E EBITDA



A review of large REITs indicates that these businesses support investment grade ratings with a debt-to-enterprise value of 36 percent on average, as compared to Pro Forma McDonald's, which would have a debt-to-enterprise value of 25 percent.

Company Name	Total Debt/ Enterprise Value	Moody's Rating	Moody's Outlook	S&P Rating	S&P Outlook
Simon Property Group Inc.	47.2%	Baa2	Stable	BBB+	Stable
Equity Office Properties Trust	50.9%	Baa3	Stable	BBB+	Stable
Vornado Realty Trust	37.4%	Baa3	Stable	BBB+	Stable
Equity Residential	38.4%	Baa1	Stable	BBB+	Stable
Prologis	31.5%	Baa1	Stable	BBB+	Stable
Archstone-Smith Trust	33.5%	Baa1	Stable	BBB+	Stable
Boston Properties Inc.	36.0%	NR	NR	BBB+	Stable
Kimco Realty Corp.	25.2%	Baa1	Stable	A-	Stable
AvalonBay Communities Inc.	27.3%	Baa1	Stable	BBB+	Stable
Median total debt/EV	36%				
Average total debt/EV	36%				
PF McDonald's total debt/EV	25%				

Notes: Stock prices as of 11/11/2001.

PF McDonald's EV assumes valuation multiple of 13x EV/FY 2006 EBITDA.

Total debt includes preferred.

Source: Pershing Square Presentation, November 2005.

Exhibit 14: Rationale for McDonald's Rejection of Pershing's Proposals (2005 and 2006)

- Valuation potential short of proposal's forecasts, not taking into account unique model
- Alignment and conflict issues would surface between parent company and franchisees
- More leverage would result in negative rating agency decision to downgrade debt, possibly increasing borrowing rates up to 150 bps, which would impact franchisee borrowing costs
- Unlikely valuation multiple expansion potential
- High friction costs from IPO spinoff
- Possible higher rents and less income for franchisees
- Already returning value to shareholders via increased dividend and large share repurchases

Exhibit 15: McDonald's REIT Valuation Estimation

Property Value = Net Operating Income / Capitalization Rate ("Cap Rate")



Net Operating Income = ~\$4.4 Billion (Derived from 2005 EBITDA of \$5.3 Billion)



Property Value = \$4.4 Billion / 7.0% Cap Rate



Property Value = ~\$64 Billion (vs. Carrying Book Value of \$29.7 Billion)^a

Although PF McDonald's would not be configured as an REIT and would not have the tax advantages of an REIT, it would have several superior credit characteristics:

- REITs are required to pay 90 percent of earnings through dividends, whereas PF McDonald's would have much more credit flexibility
- PF McDonald's would have significant brand value to support its cash flows and overall credit

^a 10-K filing for fourth quarter ending 12/31/2005. Net book value of \$19.9 billion after depreciation and amortization.

The \$64 billion of property value includes net rental income from franchises, which inflates property value and might not reflect true market value. Capitalization rate estimate provided by Deutsche Bank analyst Lou Taylor.

Source: Nicholas Yulico, "McDonald's REIT Could Be a Sizzler," *TheStreet.com, Inc.*, November 9, 2005.

Exhibit 16: Pershing's Proposal—Outside Criticisms and Counterarguments

*Mr. Ackman is clearly passionate about the company and we respect that. We also appreciate his candor in acknowledging that his previous ideas presented publicly were not workable. But the fact is, with his latest presentation, he has not presented anything fundamentally new beyond what we've discussed with him previously and what we have evaluated. Ackman's proposal will not deliver the value already being created by our current strategy.*²²

—Mary Kay Shaw, vice president of investor relations, McDonald's

*The typical hedge fund manager's idea of long-term planning is figuring out where to have dinner tonight. Their strategy is to buy stock in a company whose assets—such as real estate or cash—aren't reflected in the price of the stock, and browbeat management until they force the sale of those assets, with proceeds distributed to them and other shareholders. Then they grab their money, and move on to their next quarry.*²³

—Dan Miller, *Chicago Sun-Times* (regarding Pershing/McDonald's)

*Ackman was off-base in arguing that McDonald's has been a "slacker." In fact, the company's U.S. operations are the envy of the industry. After all, franchisees want to see the company put their own skin in the game first.*²⁴

—Peter Oakes and Scott Waltmann, Piper Jaffray analysts

*The company is going to get to these [earnings] levels by themselves regardless of the push Ackman is putting on. In the end it's going to be a slow process . . . I'm OK with that as a shareholder because I think we get to the same place eventually.*²⁵

—Herb Achey, U.S. Trust

*By creating a separate restaurant company, you may create some kind of diametrically opposing forces that in the long run could be detrimental, not beneficial, to shareholders.*²⁶

—Scott Rothbort, LakeView Asset Management

*If McDonald's leveraged up their balance sheet to do a share repurchase, their credit rating would be under great pressure. The lower the credit rating, the higher their interest rate becomes and the more expensive it becomes to finance expansion.*²⁷

—A Standard & Poor's Director

*We think the greatest long-term risk of a McOpCo spinoff is its potential damage to franchise-company relations. With its current ownership of 2,000 U.S. stores, McDonald's communicates to franchisees its focus on the bottom line and not just sales. Conversely, by not having any involvement in restaurant operations as the proposal suggests, McDonald's would likely tarnish the franchisees' trust of the company. Overall, spinoff would threaten the three-legged stool.*²⁸

—Mark Wiltamuth & Dana Greenberg, Morgan Stanley

*On the surface, there is a lot of merit to the argument. Ackman's view is that the market is misvaluing the company and I'm inclined to agree with him. The guy has got very good arguments, and I think the company owes its shareholders a reasoned response.*²⁹

—Leon Cooperman, Omega Advisors

²² McDonald's press release, January 18, 2006.

²³ Dan Miller, "Greedy Mac Attack Bad for Business," *Chicago Sun-Times*, December 2, 2005.

²⁴ Nichola Groom, "McDonald's Investors Unswayed by Activist Proposal," *Reuters*, January 19, 2006.

²⁵ *Ibid.*

²⁶ Deepak Gopinath, "Hedge Fund Rabble-Rouser," *Bloomberg Markets*, October 2005.

²⁷ Jargon, "Ackman 101."

²⁸ Mark Wiltamuth and Dana Greenberg, Morgan Stanley Equity Research North America, November 1, 2005.

²⁹ "McDonald's Rejects Shareholder Plan to Restructure," *Reuters*, January 18, 2006.

Exhibit 17: Differences Between Pershing Square's Proposal and McDonald's Management's Plan (\$ in billions)

	Pershing Proposal (Sept. 2005)	Pershing Revised Proposal (Jan. 2006)	McDonald's Management's Plan
Dividends	Unspecified	\$1.7	\$5–6 total dividends and share repurchases payout in 2006 and 2007 ^a
Share repurchases	\$12.6	Unspecified	
IPO proceeds (post-tax)	\$3.3	\$1.3	None
Secured debt issue	\$14.7	None	None
Debt reduction	\$5.0	None	None
Transaction fees	\$0.3	Unspecified (less than \$0.3)	Minor amount for refranchising

^a 2005 payout was dividends of \$850 million and repurchases of \$1.2 billion (\$2.05 billion total).