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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Yesterday, I read an article on CNNMoney.com by a certain Emily Jane Fox. The headline caught my eye: “McDonald’s, KFC, Burger King Workers Protest in NYC.” I love reading about a good protest as much as the next person, if for no other reason than to wonder at the thought process behind it.

Not surprisingly, it seems fast food workers want to make more money in New York. But, who doesn’t want to make more money, with the possible exception of Warren Buffett? After all, everything else being equal, more money is generally better than less. But was or is there merit to the workers’ complaints?

The tone of Ms. Fox’s writing would suggest she believes there is. She foisted upon the American public a woman by the name of Pamela Waldron, who makes $7.75/hour working as a cashier at the KFC in Penn Station; a job she has held for 8 years. Of course, this wage is $0.50/hour more than the Federal minimum wage.

As Ms. Fox points out in her article: “KFC worker Waldron says she would be homeless with her kids if it were not for her husband's union-represented job at the grocery store chain Pathmark.” Hmm. I wonder why the adjective phrase ‘union represented’ is in there, don’t you? Wouldn’t it have been enough to simply point out her husband works at the grocery, and they need both jobs to make ends meet? Why the union talk?

Well, it seems as though various unions are behind the community organization which is supporting these protests. As the article points out:

> Workers say they are asking for a pay raise to $15 an hour and the right to form a union. Currently, the median pay for the nearly 50,000 fast food workers in New York City is $9 an hour, or $18,500 a year, according to the New York Labor Department. That's about $4,500 lower than Census Bureau's poverty income threshold level of $23,000 for a family of four.

Wow. What to make of that paragraph? $18,500/year isn’t a lot of money to support a family of four, particularly in New York, right? Only $9/hour? Whew. The fast food meanies are certainly putting it to their employees, aren’t they? I mean, a union could improve the employees’ lot in life, couldn’t it?

Well, it would if you make the assumption fast food work is career type work, and most people working in McDonald’s, et al, are trying to support a family of four on the one income. However, I have always been under the impression there is a lot of turnover in the restaurant business, particularly in fast food. Students, teenagers, and others looking for temporary or part-time work make up the bulk of this workforce, don’t they? After all, it is unskilled labor, kind of near the bottom of the pyramid, and doesn’t really engender long-term employees does it?

Inside this issue:

Civilization and profit go hand in hand.

Calvin Coolidge

Something to Think About, *cont.*

Perhaps this is the reason why unions have never been able to gain much of a foothold in the fast food business: the workers are more transient, and the pay for the unskilled labor stinks, meaning employees would be less apt to join a union and pay dues. Have the unions or has the economy really come to this? Where organized labor is trying to motivate fast food workers? I guess so.

Now, consider what the protesting workers want: on average, a $6/hour raise to $15. That would be a 67% raise to you and me. But wouldn't that be fair? I mean, these companies make billions of dollars a year! They could easily afford that, and not even miss it, right? If you read the article, one might surely think it. If you read the comments after it, you would know it.

Frankly, I found the whole thing depressing, from stem to stern. I mean, what if McDonald's (MCD) gave all of its employees a 67% raise?

In 2011, MCD had revenue of $18,292.8 million in its company-operated restaurants. Expenses at these units were $14,837.9 million. This works out to be a tidy profit margin of around 23%. Not bad, huh? Maybe they would be willing to earn less? Well, you have to remember, there is also a cost associated with running the business, and corporate SG&A expenses were $2,393.7 million. Hmm.

When you add up **all the costs and all the expenses**, MCD had net income of $5,503.1 million in 2011, or $5.33 per basic common share. It closed the year at $100.33, for a Price/Earnings multiple of 18.82. With roughly 1.032 billion shares outstanding, this means the company had a market cap of around $103.6 billion, tucked away in IRAs, 401Ks, pension plans, and mutual funds of all sorts across the country. Life is good.

But, let's imagine the protestors get their way, and MCD increases payroll & employee benefits by 67% at company-operated outlets. What happens then? Well, net income falls to an estimated $3,396 million, which is still a lot of money in absolute terms. However, with the same number of shares outstanding, earnings per share would fall to $3.29. At a P/E multiple of 18.82, the new share price for MCD is, or would be, $61.86. With 1.032 billion shares outstanding, the 'new' market cap is $63.9 billion. That is still a big company.

However, that is about $39.7 billion less than what it was! So, that 67% raise, which generates an additional $3.071 billion in payroll & employee benefit expenses COSTS the economy $39.7 billion in WEALTH. Further, MCD ends up paying about $962 million LESS in income taxes than previously.

That is the way it works with public traded companies. Investors pay some multiple above the level of profitability. Historically, this number has averaged around $15 or so. As such, every $1 in reduction of corporate earnings works out to be roughly a $15 reduction in wealth. Sorry; but that is the way it works. So, put the screws to the company; pay the employees whatever they want! Just know, by doing so, you end up costing society a heckuva lot more in wealth than whatever income you redistributed.

But won't companies just raise their prices to offset the increased costs? I love this line of reasoning, because don't you think MCD would be selling Big Macs for 67% more IF they could get away with it? I mean, if companies could blithely increase their prices to counterbalance increases in cost, why would any company ever go out of business?

What's more is how does it help the consumer IF the company raises prices? Is it in my best interests? Would I will be willing to buy $10 value meals at MCD or elsewhere? Not hardly likely.

So, while increasing the pay of fast food workers across the country might make writers and others feel good about themselves, the truth of the matter is simple: society pays a much higher cost IF the new wage is higher than the market clearing wage, or otherwise artificially set. The only way for a company to control its expenses is to have costs set at a market clearing rate. Artificially setting labor costs above the market rate only serves to reduce corporate profitability, and therefore investor wealth.

As far as MCD and other fast food restaurants are concerned, the easiest way to control costs, and therefore increase profitability, is to keep wages as low as possible given a certain level of productivity. When I did the math with the company-operated restaurants, keeping all other things equal, the 67% increase in wages & benefits virtually eliminated all operating profit….taking it down to about $384,000 on sales in excess of $18 billion.

To illustrate this even better, meet Bob: he has worked for 40 years, and is getting ready to retire with $300,000 in his 401K plan. Bob has kept the pedal to the metal, and has the whole thing invested in the Vanguard S&P 500 Fund. He is by no means rich, but he thinks he will be able to get by with his 401K, his wife's 401K, and both Social Security checks.

Bob read Ms. Fox's article and supports the protestors. While he made more money than they do, he always felt cheated by upper management who had all the perks he didn't. All that profit, and all he had to show for it at the end of 40 years was $300,000 he had scraped and saved away, while that guy Flanders ended up with a golden parachute.

What Bob doesn't realize is he has $2,148 indirectly invested in MCD, and another $702 in Yum Brands (KFC and Taco Bell). While that isn't a fortune, you know, Bob had to work for it. While he cheers on Ms. Waldron and her efforts, is he really prepared to see the value of his account go down? I mean, if we use those numbers I calculated for MCD stock, and apply them to both companies here, Bob could stand to lose around $1,093 IF both companies fork over those types of fat raises.

Is Bob that altruistic? Or do you think perhaps Bob, and maybe the writer of the article and the people commenting on it, hasn't/haven't thought things through yet? You see, for all the public hand wringing and gnashing of teeth, corporate profitability is a good thing, as it is one of the most effective ways of generating wealth in our society. Why? Because investors will pay for it! And investors are you, me, and just about everyone else around you in some form or fashion.

Slash the CEO's pay? Okay, let's do that. Why don't we shave $3 million off that big meanie's paycheck? What does that do? In the bigger scheme of things, it doesn't do that much. From the numbers I crunched, Bob stands to make about $2 from that. Throw MCD's 18.82 multiple on it, and it represents about $56.5 million in wealth. Compare that to the close to $40 billion lost by handing out a 67% wage increase across the board at company-operated stores, and you come to a less than politically popular conclusion: CEO pay makes for great headlines, but it is a drop in the bucket at most large, publically traded companies. Besides, most CEO's pay is heavily incentive based. IF the CEO can generate, say, an additional $5 billion in wealth due to controlling employee related costs, what is a $2 million bonus? Or if they can save that same $5 billion in a down market? The answer is the same: relatively nothing.

Of course, this is just one way of looking at the situation. We could debate the value of the worker's output, including Ms. Waldron, until the cow's come home. We could argue until we are blue in the face about the need for more training and worker responsibility. Where the rubber meets the road, and it ordinarily does, companies will try to minimize their costs for any given level of worker output because that is how they generate profits which, in turn, generate an outsized amount of investor wealth. That, my friends, is good for society, in aggregate, even IF some people have a bigger slice of the pie than others.

So, the next time you read articles like the one I read yesterday, please go on the accompanying message board, and say something along these lines: "Gosh, I would love to see the workers make more, but unless there is a commensurate increase in productivity, it just isn't fair to the rest of us."

Important Economic Releases

Release	Survey	Actual	Prior	Comments
Durable Goods Orders (Oct)	-0.7%	0.0%	9.2%	But for the fiscal cliff, this market would have had a really nice rally in November. The numbers have been much more solid than the recent angst would suggest. So, write your representatives and tell them to do whatever it takes to get a deal done, so we can end the year on a good note. Then we can adjust your portfolios accordingly at the start of 2013.
Consumer Confidence (Nov)	73.0	73.7	73.1	
New Home Sales (Oct)	390K	368K	369K	
GDP 3Q (2nd stab)	2.8%	2.7%	2.0%	
Initial Jobless Claims	390K	393K	416K	
Personal Income (Oct)	0.2%	0.0%	0.4%	
Chicago Purchasing Managers (Nov)	50.5	50.4	49.9	

Tables & Data Points

STOCKS	Dow Industrials	S&P 500	NASDAQ	Russell 2000	Nikkei 225 (¥)	DJ STOXX 50 (€) Price
12/31/10	11,577.51	1,257.64	2,652.87	783.65	10,228.92	2,792.82
12/31/11	12,217.56	1,257.60	2,605.15	740.92	8,455.35	2,216.55
11/8/12	12,811.32	1,377.51	2,895.59	793.65	8,837.15	2,479.13
11/15/12	12,542.38	1,353.33	2,836.94	769.48	8,829.72	2,461.77
11/22/12	12,836.89	1,391.03	2,926.55	798.38	9,366.80	2,535.09
11/29/12	13,021.82	1,415.95	3,012.03	823.20	9,400.88	2,581.69

BONDS	3-Mo UST	6-Mo UST	2-Yr. UST	5-Yr. UST	10-Yr. UST	30-Year UST
12/31/10	0.13	0.19	0.60	2.01	3.30	4.34
12/31/11	0.01	0.06	0.24	0.83	1.88	2.90
11/8/12	0.09	0.14	0.26	0.64	1.62	2.75
11/15/12	0.08	0.13	0.24	0.62	1.59	2.73
11/22/12	0.09	0.14	0.27	0.68	1.68	2.82
11/29/12	0.08	0.13	0.26	0.63	1.62	2.80

OTHER	Prime	Fed Funds	3-Month LIBOR	Gold/troy oz.	Oil—WIT/brl.	$/Euro	JPY/$	$/GBP	CAD/$
12/31/10	3.25	0.25	0.30	1,421.40	91.38	1.337	81.19	1.559	0.994
12/31/11	3.25	0.25	0.58	1,566.80	98.83	1.296	76.99	1.551	1.017
11/8/12	3.25	0.25	0.31	1,726.00	85.09	1.275	79.47	1.599	1.000
11/15/12	3.25	0.25	0.31	1,713.80	85.45	1.278	81.18	1.587	1.001
11/22/12	3.25	0.25	0.31	1,728.20	87.38	1.289	82.46	1.594	0.997
11/29/12	3.25	0.25	0.31	1,727.20	88.08	1.298	82.12	1.604	0.992

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