



# McDonald's Corporation

NYSE: MCD

**BUY**

*Intrinsic Value: \$202.07*

## Executive Summary

A potential of an economic downturn in the near future has led us to look into less cyclical companies. McDonald's is driven by the amount of disposable income that people have. However, due to the affordable prices and value-driven menu, we believe under economic pressures, McDonald's will be able to perform well with respect to the market. McDonald's intrinsic value's potential upside is 10.25% due to a sales growth increase at the beginning of 2019.



## McDonald's Corporation - Financial Statements

Figures in Millions Except Per Share Data

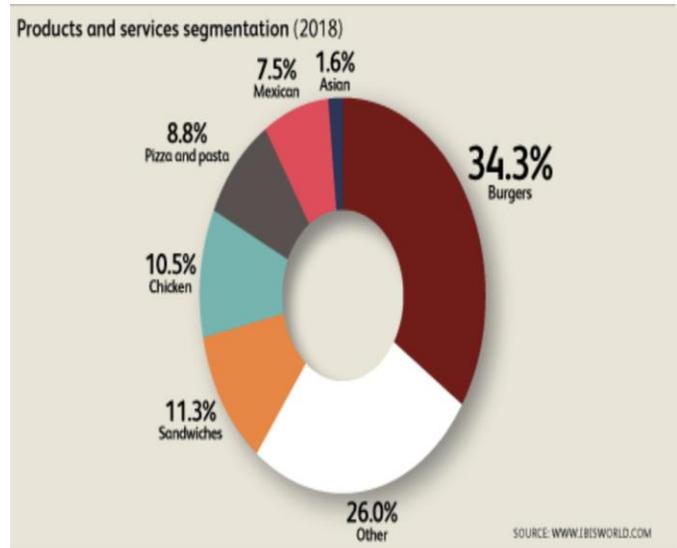
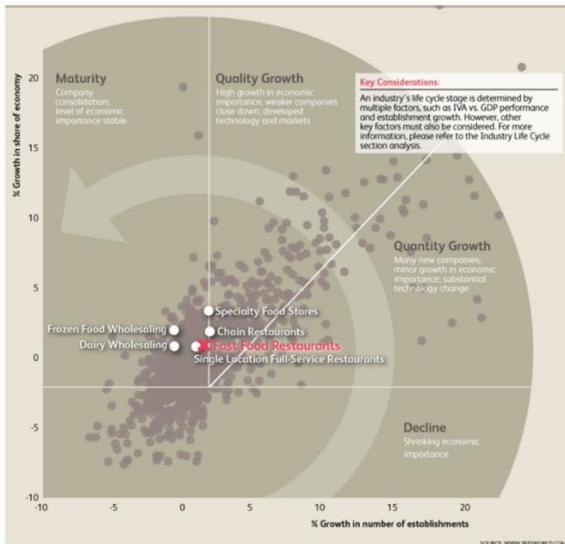
		Actual FYE 12/31				
		2014A	2015A	2016A	2017A	
<b>Summary Information</b>						
Ticker:	MCD	<b>Summary Financials</b>				
Current Price	\$ 183.29	<b>Revenue</b>	27,441.30	25,413.00	24,621.90	22,820.40
Shares Outstanding	770.91	<b>Growth</b>	-2.40%	-7.39%	-3.11%	-7.32%
Market Capitalization	141,300.09	<b>Gross Profit</b>	10,455.70	9,789.20	10,204.70	10,620.80
Plus Debt	29,542.30	<b>Gross Margin</b>	38.10%	38.52%	41.45%	46.54%
Minus Cash & Equivalents	2,463.80	<b>Operating Profit</b>	9,632.60	8,936.30	9,602.60	10,213.10
Enterprise Value	\$ 168,378.59	<b>Operating Margin</b>	35.10%	35.16%	39.00%	44.75%
		<b>Adjusted EPS</b>	4.85	4.96	5.7	6.67
52-Week High	\$ 190.88	<b>Growth</b>	-12.70%	2.27%	14.92%	17.02%
52-Week Low	\$ 146.84					
Dividend Yield	2.53%					

## Company Overview

McDonalds is a quick service restaurant with over 37,000 restaurants opened worldwide serving over 68 million customers a day. They are known for a value driven menu that offer a variety of products at various price points to target the low-middle income class. The way McDonalds makes revenue is through company operated restaurants however, about a third of their revenues comes from franchising. However, McDonald's profit margins are significantly higher through the revenues generated from franchising, consequently, McDonald's wants to transition to 95% of their restaurants to be franchised.

## Industry Outlook

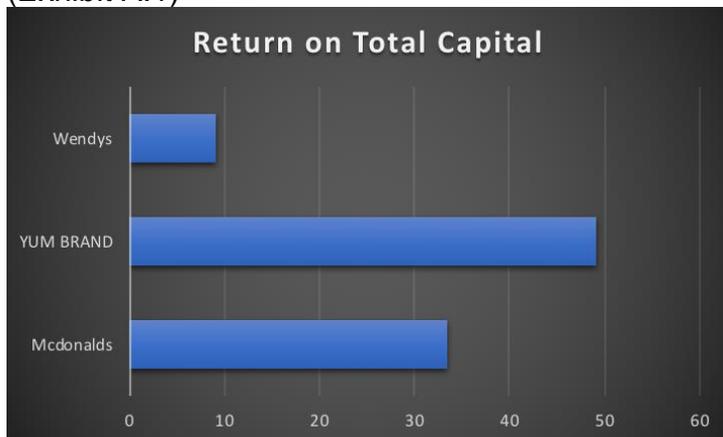
The Industry for fast food restaurants is growing at a rate of 1.2% per year. It has transitioned from growth to maturity. In the fast food industry, revenues are sensitive to consumer spending. Therefore as people's income continues to increase, the amount of disposable income they have increases as well which translates to more consumer spending. The products that are sold in the industry is comprised of burgers, pizza, sandwiches, etc. Revenues within the industry will be comprised from either company owned stores or franchises.



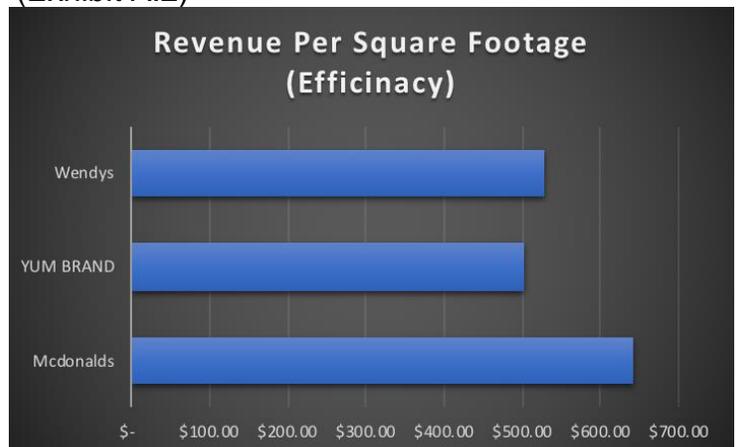
## Comparable

Well known competitors to McDonalds would be Wendy's and Yum Brand. The two metrics we used to compare the companies was the Return on Total Capital and Revenue per Square footage. Return on Total Capital shows the amount of return that a company money that a company produces off of the Debt and Equity. As shown in Exhibit (A.1) Yum brand has the highest Return on Total Capital; however, McDonalds makes up the lower Return on Total Capital with how efficient their restaurants operate as can be on their Revenue/ Square Footage Exhibit (A.2)

(Exhibit A.1)



(Exhibit A.2)



## Catalysts

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### **Customer Focused Strategy**

In 2015, McDonald's began an initiative to become customer-centric through improving restaurants and operations. In 2017, McDonald's accelerated their customer-centric strategy. The strategy consists of retaining existing customers, regaining lost customers, and converting casual to committed customers. McDonald's is targeting low- to middle- income consumers to capture more market share. The accelerated strategy has benefitted McDonald's greatly resulting in an increase of 3.6% comparable sales and an increase of 1.0% comparable guest count. McDonald's continues to capitalize on the accelerated strategy.

McDonald's has been revamping their menu for the past couple of years to target their customers. In 2016, McDonald's introduced their all-day breakfast menu generating an increase of sales. McDonald's reintroduced their dollar menu, a McPick 2 menu, and a \$6 meal deal in 2018. In addition to the cost-conscious menu, McDonald's is creating a healthier menu by reducing antibiotics in beef patties and introducing 100% fresh beef, instead of frozen beef.

### **Technological Advances**

McDonald's is continuing to integrate new technologies into their restaurants. To capture new customers and existing ones, McDonald's created new technological advances. McDonald's enhanced the existing service model through curbside pick-up, mobile app, and self-order kiosks. The mobile app has different capabilities such as deals for customers to utilize and ordering in advance for eating in, taking out, or picking-up curbside. The McDonald's app has over 20 million users. Furthermore, McDonald's self-order kiosks provide customers a chance to personally order food on a large screen and cutting costs for restaurants.

### **Refranchise and Renovation of Restaurants**

Currently, McDonald's has 92% franchised restaurants and a long-term goal of 95%. The goal of refranchising restaurants is to provide a stable revenue flow while lowering general and administrative costs. Moreover, McDonald's is revamping most of the restaurants to have an appealing and more modern look. Also, the restaurants contain new fixtures, furniture, tables, and lighting. McDonald's partnered with Uber Eats to provide a convenient option for delivering food to customers.

## Investment Thesis

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Transitioning to the customer-centric initiative through the investment of self-serving kiosk and the mobile app has allowed McDonald's to expand their market presence. The investment in modernization will serve to attract new customers while retaining current customers. Technology such as Self-Serving displays will be able to provide customers with a more convenient way to order while also reducing labor costs in the long term. We believe that McDonald's will provide great value to our portfolio and for those reasons, this makes for a good opportunity to buy.

## Valuation, Recommendation, &amp; Risks

McDonald's Discounted Cash Flows	
<b>Inputs</b>	
WACC	4.13%
Cost of Equity	4.06%
Cost of Debt	6.00%
Tax Rate	25.00%
Terminal Growth Rate	3.00%
<b>Valuation</b>	
Free Cash Flow at Year 5	\$ 2,276.97
Terminal Value	\$ 207,189.59
PV of Terminal Value	\$ 169,218.54
PV of Free Cash Flows	\$ 13,638.75
Enterprise Value	\$ 182,857.28
Less Debt	\$ 29,542.30
Plus Cash	\$ 2,463.80
Market Value of Equity	\$ 155,778.78
Shares Outstanding	770.91
Share Price	\$ 202.07
Current Share Price	\$ 183.29
Potential Upside	10.25%

- Assumptions used according to McDonald's 2017 10-K
  - Beginning in 2019, sales growth of 3-5%
  - Operating margin in mid-40% range
  - Effective income tax rate 25-27%
- LT growth rate & TV growth rate is 3%
- Risk-free: 2.9% Beta: 0.21 Market risk premium: 5.5%
  - Using CAPM = 4.1%
- Five years forecasted DCF
  - Intrinsic value: \$202.07
  - Potential upside: 10.25%

**Risks**

**Consumer Taste shifting:** The biggest risks that McDonald's is facing is the shift in consumer tastes to Healthier alternatives. They have been affected by the stigma that associates them to unhealthy eating. The shift has been affecting McDonald's top line as can be seen with decreasing revenues over the past five years.

**Mitigation:** McDonald's has been working hard on changing the way consumers view their products with Healthy lifestyle style Marketing Campaign. The goal is to disassociate their brand image with an unhealthy lifestyle.

**Modernization Costs:** McDonald's will continue to invest in modernizing their restaurants which can be seen with the self-serving displays that most McDonald's have today. The investment in self-serving displays may not generate expected returns.

**Mitigation:** Although self-serving displays may initially be costly, it will be a good investment in the long term as it will be able to reduce labor costs as wage rates increase in the future.

**Food Safety:** McDonald's ability to ensure their products are safe for consumption is crucial to their business. Their products are exposed to foodborne illness or food contaminants. In any circumstance, whether there are rumors of compromised products or actual compromised products, the results would lead to significant financial losses.

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## Appendix

**Free Cash Flow Buildup**

Smm	Projected Annual Forecast							
	2016A	2017A	2018A	2019P	2020P	2021P	2022P	2023P
Period				1	2	3	4	5
Total Revenues				\$21,907.6	\$22,564.8	\$23,241.8	\$23,939.0	\$24,657.2
EBITDA				8,763.0	10,154.2	10,458.8	10,772.6	11,095.7
EBIT				6,287.5	6,769.4	4,183.5	4,309.0	4,438.3
Tax rate				25.0%	25.0%	25.0%	25.0%	25.0%
<b>EBIAT</b>				<b>\$4,715.6</b>	<b>\$5,077.1</b>	<b>\$3,137.6</b>	<b>\$3,231.8</b>	<b>\$3,328.7</b>
Depreciation & Amortization				1,314.5	1,353.9	1,394.5	1,436.3	1,479.4
Accounts receivable				(197.6)	(217.4)	(239.1)	(263.0)	(289.3)
Inventories				(0.9)	(1.2)	(1.5)	(1.9)	(2.2)
Prepaid expenses				(149.1)	(176.0)	(207.6)	(245.0)	(289.1)
Accounts payable				13.9	18.8	23.9	29.4	35.4
Accrued expenses				91.7	111.4	134.9	163.3	197.7
Capital expenditures				(1,795.9)	(1,878.9)	(1,959.2)	(2,036.0)	(2,183.6)
<b>Unlevered free cash flows</b>				<b>\$3,992.2</b>	<b>\$4,287.7</b>	<b>\$2,283.5</b>	<b>\$2,314.9</b>	<b>\$2,277.0</b>
Discount Rate (WACC)				4.1%	4.1%	4.1%	4.1%	4.1%
Present value of free cash flows				\$3,833.7	\$3,954.2	\$2,022.3	\$1,968.8	\$1,859.7
<b>Sum of present values of FCFs</b>				<b>\$13,638.7</b>				

**Terminal Value**

## Growth in perpetuity method:

Long term growth rate	3.0%
WACC	4.1%
Free cash flow (t+1)	2,345.3
Terminal Value	207,189.6
<b>Present Value of Terminal Value</b>	<b>\$169,218.5</b>