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Why We Feel McDonald's Is Undervalued

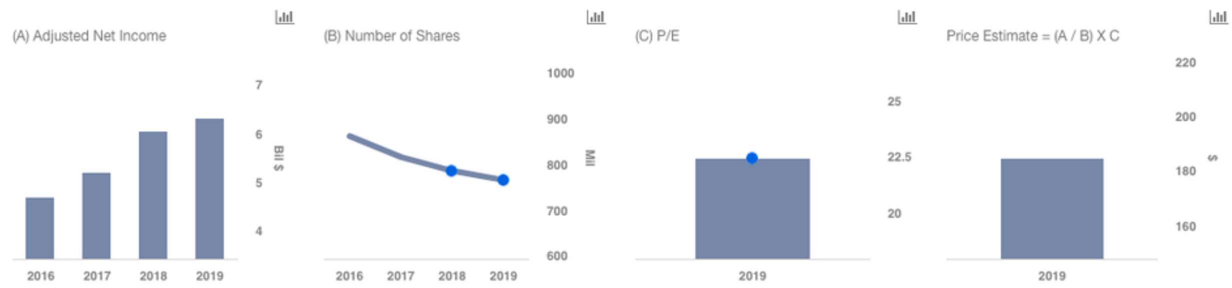
Trefis Team Contributor
Great Speculations Contributor Group
Markets

This Aug. 8, 2018, file photo shows the logo of McDonald's at flagship restaurant in Chicago. (AP Photo/Nam Y. Huh, File)

Over the past two years, McDonald's (NYSE:MCD) has been working aggressively on several initiatives to shed its image of an "unhealthy, junk food" destination, and customize its offerings to suit changing customer requirements. These changes have started showing results, with positive comparable sales leading to a growth in profits. While the burger giant has been faced with declining revenue in recent quarters, this has been a consequence of the refranchising of its restaurants that the company has been undertaking for a couple of years. The company's long-term goal is for 95% of McDonald's restaurants to be owned by franchisees, and at the end of FY 2017, this figure stood at 92%. This strategy has resulted in cutting costs for the burger giant, and has led to an improvement in margins, and consequently, the earnings. Another benefit of the franchise model is that the company can take advantage of the significant real estate portfolio it has built up over the years, and collect rent and royalty income in the years to come.

We have a $185 price estimate for McDonald's, which is higher than the current market price. The charts have been made using our new, interactive platform. The various driver assumptions can be modified by **clicking here for our**

interactive dashboard on Estimating McDonald's Fair Price, to gauge their impact on the revenue, earnings, and price per share metric.



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We have arrived at a $185 price estimate for McDonald's based on revenue projections of $20.9 billion for 2019, net income margin of 30.2%, a P/E multiple of 22.4, and a share count of 765.5 million. The market price stood at $163 as of September 24, 2018, implying our price estimate is higher by 14%.

The revenue decline of 7.6% and 1% expected for 2018 and 2019, respectively, is a result of the refranchising efforts, as mentioned earlier. While the sales are expected to fall, we expect the comparable sales to show an improvement. This is because of the following reasons:

1. Value Meals: McDonald's began 2018 by launching its $1, $2, $3 menu aimed toward its value-conscious customers. Earlier a similar program was discontinued in 2014 since it impacted margins adversely. However, this time around McDonald's is confident that other cost efficiencies (around marketing and lower fixed costs due to higher traffic) will ensure that margins do not decline due to this value platform. A higher number of items per order for $1, $2, $3 Dollar Menu transactions was one of the drivers for the comparable sales growth in the first half of 2018, and should continue to positively impact the results the rest of this year. Moreover, the company also introduced two for $4 breakfast in mid-March, which makes MCD more competitive in the breakfast daypart, helping ease the soft morning sales. In August, the company rolled out a 2 for $5 Mix & Match deal.

2. Technology Initiatives: McDonald's is revamping its stores to create "Experience Of The Future" restaurants which will have self-serve kiosks and table service. The company's mobile ordering and payment system continues to expand (in 20,000 restaurants currently) and McDonald's is also effectively using the data captured via this platform for personalized marketing and customizations. MCD has also introduced delivery in 13,000 restaurants across 60 markets, spurred by its partnership with UberEats. CFO Kevin Ozan has stated that the delivery check size is generally one-and-a-half to two times the in-store check. In a number of its top markets, delivery has increased to form roughly 10% of the total sales. Consequently, an effective use of technology is another key growth factor for McDonald's in 2018, as it can drive the average check higher. McDonald's also provided home delivery in many countries whose teams participated in the 2018 FIFA World Cup, such as England, Spain, France, Germany, and South Korea, which may have had a positive impact on the revenues.

3. New Launches: McDonald's earlier launched its fresh beef burgers in select markets in the U.S. to a good response, and completed its national roll-out in Q2. CEO Steve Easterbrook noted that in the pilot markets of Dallas, "90% of customers who tried the burgers said they'd buy them again." These premium items helped to drive the average check size higher. The company has also launched its premium burgers in other countries, such as Gourmet Creations in Australia and Mighty Angus in Canada. Increased sales of these products can help to increase the average revenue per consumer.

We expect the net income margin to improve from 22.8% in 2017 to 28.6% in 2018, and further to 30.2% in 2019, primarily as a result of the refranchising efforts of the company. This step, as mentioned earlier, has resulted in an improvement in the bottom line due to the fact that franchised stores carry higher margins, and warrant a lower level of general and administrative expenses. Furthermore, the company has also benefited from the reduction in the corporate tax rate, and consequently, the metric is expected to fall from 39.4% in 2017 to between 24% and 26% in 2018 and 2019.

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