

McDonalds (NYSE: MCD)

A company in an earnings upgrade cycle

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Sometimes wonderful investment opportunities are hiding in plain sight. McDonalds, the famous Golden Arches, is one of the most competitively advantaged companies in the world. Its restaurants blanket the world, providing consumers with a convenient, well priced menu from breakfast until late into the night. But films like 'Supersize Me' made obvious a growing disenchantment with what it offered, and a business transformation was needed. Thus, in order to stay relevant to fast-changing consumer preferences, McDonalds has been updating its brand and operations across the globe.

Why we like it

A structurally positive shift in the business model

First, McDonalds has evolved its model from being ~80% franchised to soon approach 95%, retaining just a small company operated base of stores that allow it to credibly innovate. The restructure is creating an even more capital efficient, shareholder friendly structure that leverages the strengths of local entrepreneurs.

Improving the customer experience

Since assuming the CEO role in 2015, Steve Easterbrook has led a strategy to modernise the famous burger chain. This started years ago in its lead international markets – including the UK, Australia and Canada - which together account for 40% of operating profits, and the results have been excellent. It is an all-encompassing update including, to touch on a few, improving food quality, removing artificial ingredients, adding digital options for ordering and paying, modern restaurant designs and expanding to delivery. 'Experience of the Future' (EOTF) is the internal name given to the holistic upgrade of its restaurants.



New-look McDonalds restaurants. Source: Google images

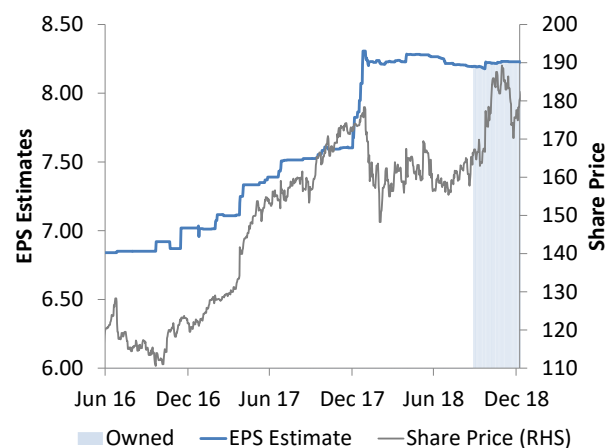
Similar benefits are likely in the US

Slow to begin in the US, EOTF is now being rapidly deployed. 4,000 US restaurants were completed in 2018, with 8,000 expected by end 2019, transforming the brand in its home market. Indications are for strong improvements in the US business (also 40% of operating profits) over the next few years. The average sales per restaurant in the US today lags the lead international markets, by 25% so the potential is huge.

An earnings upgrade cycle

Figure 1 shows that McDonalds is in an earnings upgrade cycle that the share price has followed the earnings up. The stock was added to the portfolio in September 2018.

Figure 1: McDonalds earnings estimate and share price



Source: Bloomberg

Outlook: higher earnings, lower risk

Together, these changes are improving returns on capital, lowering operating leverage but most importantly, we anticipate earnings ahead of expectations over the next several years. McDonalds was and remains a top holding in the Alphinity Global Equity Fund.

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