We're Loving This Buy the Dip Opportunity

Everyone wants to buy a great company at a cheap price. Unfortunately, those opportunities are few and far between. Most of the time, when you find a company that is the undisputed leader in its industry, highly profitable, and growing, the stock will trade at a significant premium.

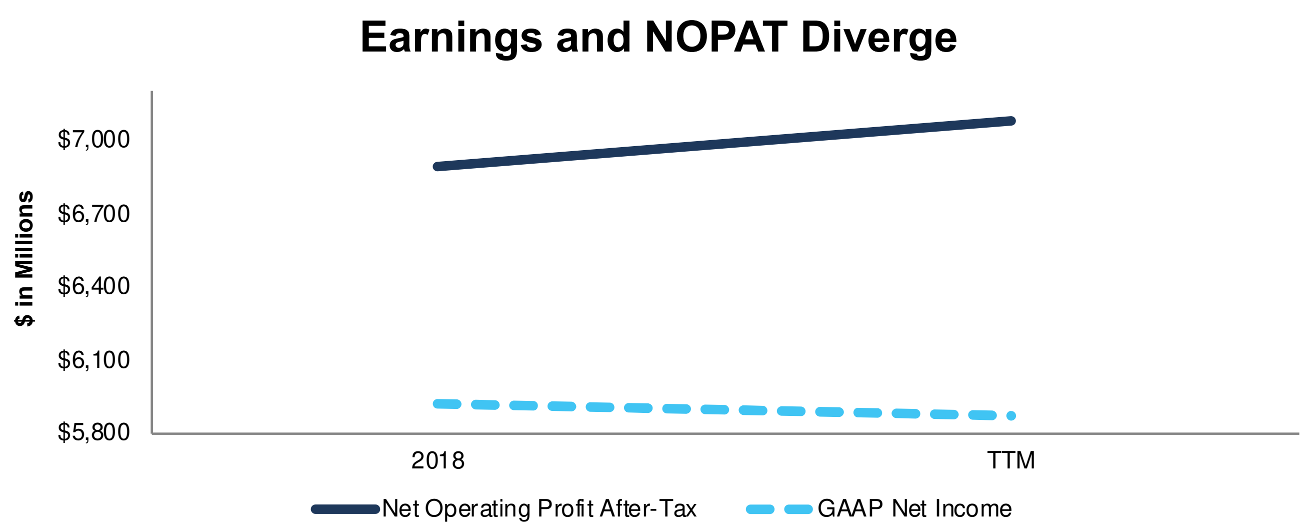
Investors should jump at the opportunity to buy the dip (13% over the past three months) in this restaurant stock. The company's earnings miss is the result of accounting distortions[1] – identified by our "novel dataset" featured in "Core Earnings: New Data and Evidence". The recent upheaval of the executive team is also overblown, and we expect this company to continue to deliver strong results. McDonald's Corporation (MCD: $194/share) is this week's Long Idea.

GAAP Earnings Mislead Investors

MCD trended lower beginning in August 2019 due to concerns over increased competition. Those concerns seemed valid when the company reported third quarter earnings per share of $2.11 on October 22, missing consensus expectations of $2.20. MCD has missed expectations in all three quarters of 2019.

However, our research shows that these disappointing earnings results don't tell the whole story. While MCD's GAAP net income declined through the first nine months of 2019, its after-tax operating profit (NOPAT) continues to rise. See Figure 1.

Figure 1: MCD's GAAP Net Income and NOPAT: 2018-TTM



Sources: New Constructs, LLC and company filings

The decline in TTM GAAP net income is primarily attributable to the change in MCD's "Asset dispositions and other (income) expense, net," disclosed on page 27 of its latest 10-Q. Through the first nine months of 2019, MCD has $38 million in asset disposition and other expense. Through the first nine months of 2018, it earned $45 million in income from this line item, primarily due to sales of restaurant properties in the U.S. and Australia.

The change in this non-operating line item decreased MCD's pre-tax income by $83 million year-over-year through the first nine months of 2019. Using MCD's cash tax rate of ~25%, that equates to a $62 million hit to GAAP net income, or 111% of the decline in GAAP net income between 2018 and the TTM period.

Investors who rely on reported earnings will believe that MCD's profits are declining, when the core earnings are growing.

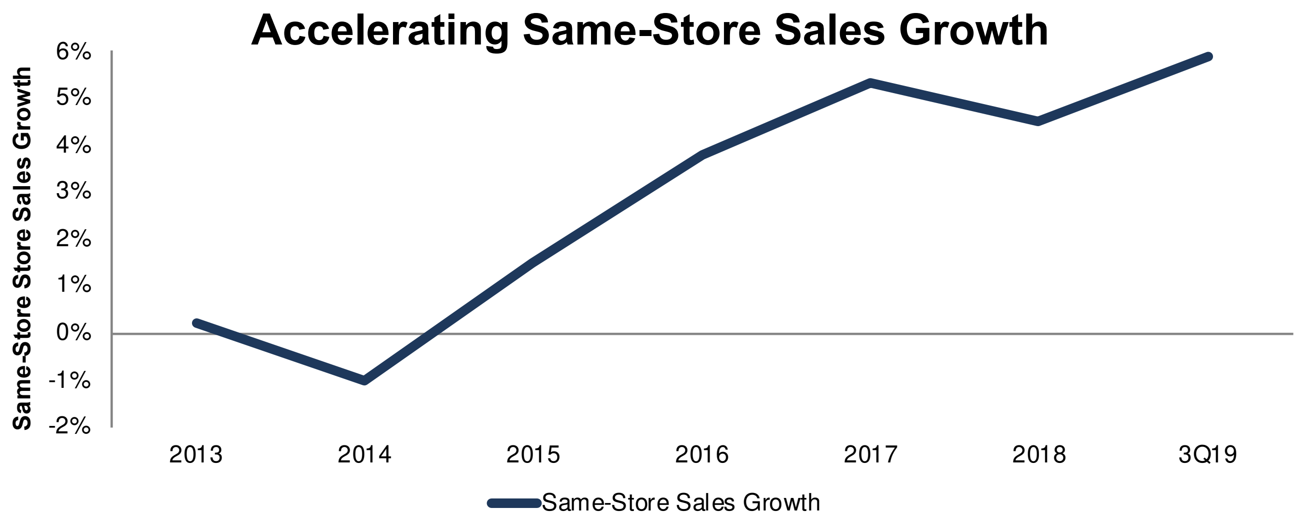
1 See our Earnings Distortion Scorecard for other stocks with significant misinformation in their earnings.

Growing Same-Store Sales

In addition to our forensic accounting adjustments, MCD's accelerating same-store sales growth shows that the decline in GAAP earnings does not accurately reflect the fundamentals of the business.

MCD reported that same-store sales grew by 5.9% year-over-year through the first three quarters of 2019. MCD has improved its same-store sales growth in every year but one going back to 2015, as shown in Figure 2.

Figure 2: MCD's Same-Store Sales Growth



Sources: New Constructs, LLC, and company filings

MCD drives same-store sales growth through constant innovation in its restaurant design and menu.

Always An Innovator

Over the past two years, the company, along with its franchisees, invested heavily in remodeling its locations through its "Experience of the Future" (EOTF) redesign. The redesign emphasizes a modernized aesthetic, digital kiosks for more rapid ordering, and a more convenient layout that makes delivery and mobile ordering easier.

Delivery, in particular, has been a major driver of growth. On the 3Q19 earnings call, the company projected that delivery will drive $4 billion of sales in 2019, or 4% of global sales. Delivery sales have quadrupled from just $1 billion three years ago.

Meanwhile, MCD continues to drive growth across a wide variety of markets through constant menu innovation. The company continues to grow and expand its market share in countries like Japan, Portugal, and Russia by combining its core menu with items that appeal directly to local tastes.

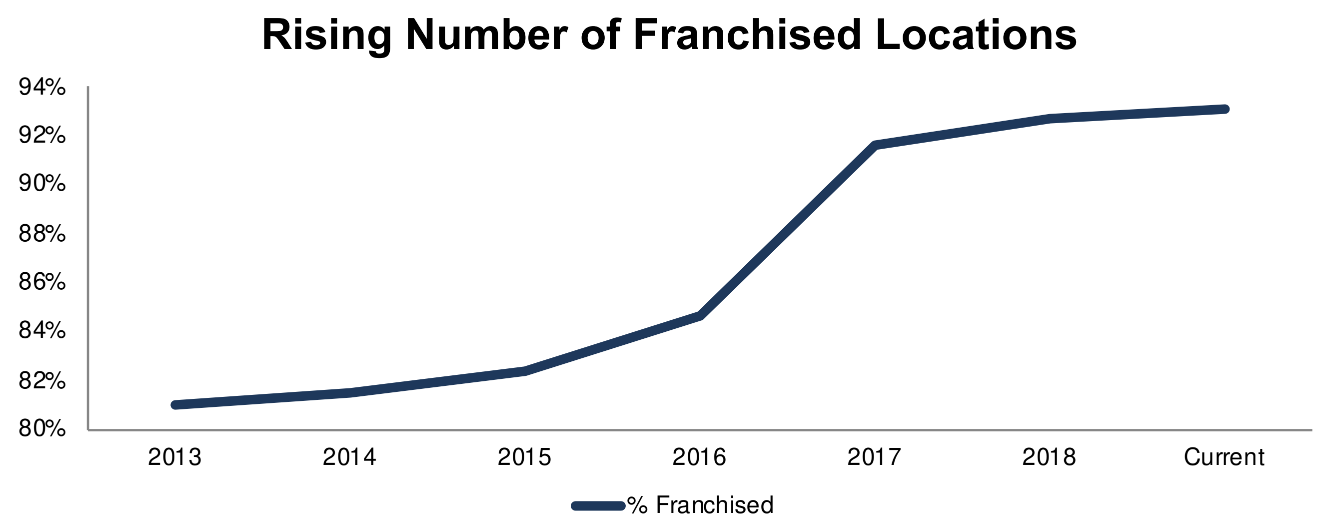
MCD also continues to innovate in its menu presentation. The company spent $300 million in March to acquire Dynamic Yield, which uses machine learning to personalize the customer experience. MCD has already implemented Dynamic Yield technology in the majority of its U.S. drive-thru locations, and plans to roll it out across the entire country by the end of the year.

These constant innovations have helped MCD's maintain its dominance in the fast food industry for decades, and we see no reason to expect that dominance to diminish.

Refranchising Strategy Pays Off

In addition to its store redesign, MCD has emphasized refranchising its locations over the past several years in order to maximize its cash flows. The percent of MCD locations run by franchisees has increased from 81% in 2013 to 93% currently. See Figure 3.

Figure 3: Percent of All Locations Franchised



Sources: New Constructs, LLC and company filings

This refranchising effort has lowered revenue, as franchised locations bring in less revenue than company-owned stores, but it has also increased margins and return on invested capital (ROIC). From 2015-2018, MCD's revenue declined by 6% compounded annually, but its NOPAT increased by 9% compounded annually.

This increase was driven by its NOPAT margin growing from 21% to 33%. ROIC also improved from 12% to 17% over this timeframe.

While there are fewer opportunities to refranchise locations now than there were a few years ago, MCD still has opportunities remaining to improve its margin and ROIC by selling some of the 2,600 remaining company-owned locations to franchisees.

CEO Change Not a Concern

In addition to its earnings miss, MCD made news recently when its CEO, Steve Easterbrook, was fired due to a relationship with an employee.

The stock dropped 3% following the news, but investors should take confidence that the new CEO, Chris Kempczinski, has been overseeing U.S. operations for the past two years and played a major role in crafting the store redesign plan.

MCD, with its long history of innovation and execution, is much bigger than any one person. CEO transitions are never easy, but the company's track record, and corporate governance, increase the likelihood that it will continue to create value for shareholders.

Trust Executives Paid For the Right Performance

The company ties a portion of long-term executive compensation to three-year return on incremental invested capital (ROIIC). Return on invested capital is the primary driver of valuation, so tying executive compensation to this metric, or a derivative of it, is the best way to align the interests of executives with those of long-term shareholders.

MCD's long track record of organizational excellence, the strong resume of its new CEO, and its high-quality corporate governance give us confidence that this CEO transition won't negatively impact shareholders.

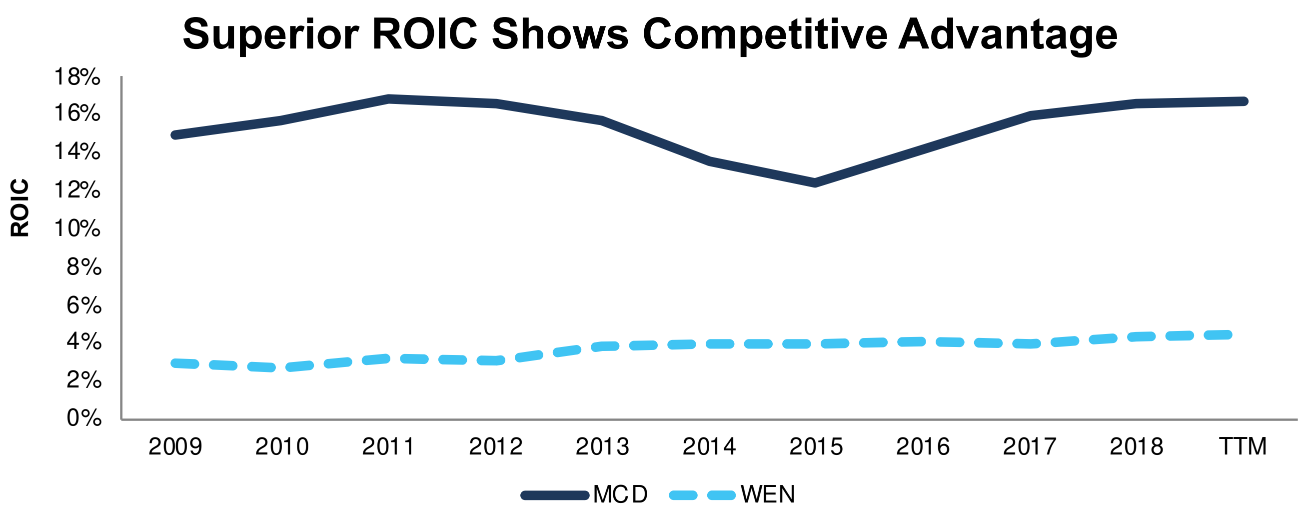
Bear Case: Competition is Overhyped

The bear case against MCD assumes that increased competition will erode its market share and profitability. Wendy's (WEN) new breakfast menu is the latest threat that has investors worried.

However, there's no real reason to believe that WEN's latest foray into the breakfast world will go better than its last attempt that flamed out in 2013. The consensus after that failure was the company couldn't break through the entrenched habits of breakfast eaters, with one analyst saying "they just moved too little, too late." If WEN was too late in 2013, it's hard to see how they'll do any better in 2019.

In addition, MCD has a much stronger track record of innovating and executing on its plans that WEN. This track record shows up in the company's respective ROICs. Over the past decade, MCD has averaged an ROIC of 15%, while WEN has averaged an ROIC of 4%. Figure 4 has details.

Figure 4: MCD vs. WEN: ROIC Since 2009



Sources: New Constructs, LLC and company filings

In a competition between these two companies, we're going to bet on MCD every time.

MCD also stacks up well against fast food competitor Burger King (QSR) and fast casual competitor Shake Shack (SHAK). QSR's ROIC of 9% and SHAK's ROIC of 6% are both well below MCD. Both companies also have significantly lower same-store sales growth.

Bears have long called for the demise of MCD at the hands of Wendy's, Burger King, and a multitude of fast casual competitors, and we've yet to see any signs of deterioration in McDonald's profits or growth.

The bottom line is that MCD has a superior business model than these firms.

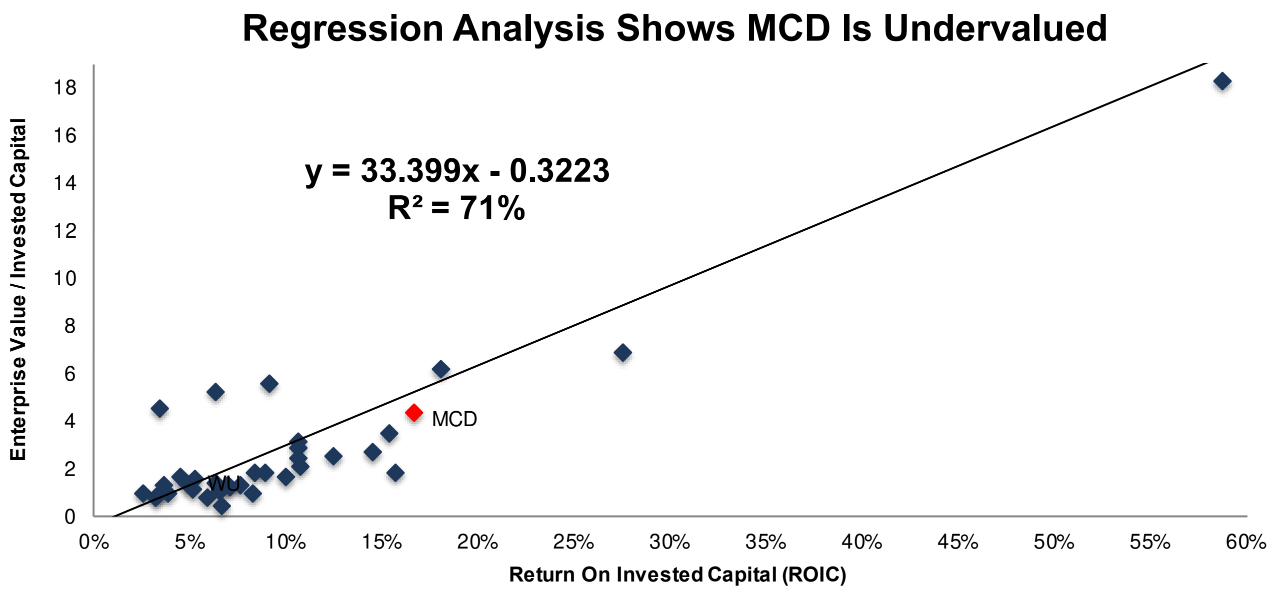
Competitors can run all the promotions they want, but any share they take from MCD has been only temporary because MCD has a lower-cost advantage. MCD can easily, if it chooses, beat competitors on price, but why should it when profits are rising so strongly. Why not let the competitors sell at or below cost and suffer lower margins?

MCD Remains Undervalued

Numerous case studies show that getting ROIC right is an important part of making smart investments. This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up. The technology that enables this research is featured by Harvard Business School.

Per Figure 5, ROIC explains 71% of the difference in valuation for the 37 restaurant stocks we cover. MCD trades at a discount to peers as shown by its position below the trend line.

Figure 5: ROIC Explains 71% of Valuation for Restaurant Stocks



Sources: New Constructs, LLC and company filings

If the stock were to trade at parity with its peers, it would be worth $236/share – 22% above the current stock price. Given its status as the largest, and one of the most profitable, companies in the industry, MCD should earn a premium valuation to its peers.

Cheap Valuation Provides Upside

MCD's cheap valuation means the stock still has significant potential upside. At its current valuation of $194/share, the stock has a price to economic book value (PEBV) of 1.2. This ratio means the market expects NOPAT to grow by no more than 20% over the remainder of its corporate life. Given the company's strong track record of growth, this expectation seems overly pessimistic.

We use our reverse DCF model to quantify the potential upside for MCD in a more realistic scenario.

If MCD can continue to improve its NOPAT margin to 35% (up from 34% TTM) and grow NOPAT by 4% compounded annually over the next decade (in line with its growth over the last decade) the stock is worth $243/share today – a 25% upside to the current stock price. See the math behind this dynamic DCF scenario.

Sustainable Competitive Advantages That Will Drive Shareholder Value Creation

Here's a summary of why we think the moat around MCD's business will enable the company to generate higher profits than the current valuation of the stock implies. This list of competitive advantages helps MCD offer better products/services at a lower price and prevents competition from taking market share.

- Unparalleled global brand
- Unmatched economy of scale
- Unique expertise in optimizing menu for local markets

What Noise Traders Miss with MCD

These days, fewer investors focus on finding quality capital allocators with shareholder friendly corporate governance. Instead, due to the proliferation of noise traders, the focus tends toward technical trading tends while high-quality fundamental research is overlooked. Here's a quick summary for noise traders when analyzing MCD:

- Declining GAAP EPS does not reflect real operating profits
- High-quality organizational culture and corporate governance should ensure smooth CEO transition

- Threat from Wendy's and other competitors is overhyped

Earnings Beat Could Drive Shares Higher

MCD's earnings misses so far this year have lowered the bar for the stock and made it likely to beat expectations going forward. The consensus EPS estimate for 4Q19 is $1.96/share, down slightly from the $1.97/share the company earned in 4Q18.

These pessimistic expectations align with the findings of "Core Earnings: New Data and Evidence," which uses our data to show that analysts are "slow to impound the implications of certain transitory gains and losses in their earnings forecasts." Investors that see thru the noise in transitory gains and losses have an advantage.

Analysts have seen that MCD's GAAP earnings are declining, so they project that decline to continue. However, our data shows that the decline is due to non-operating items, and investors should expect core earnings to continue to grow. Eventually, the GAAP earnings will catch up.

Dividends Plus Buyback Offer Nearly 6% Yield

MCD has increased its dividend for 43 consecutive years. Since 2014, the company has increased its dividend by 10% compounded annually. The current annualized dividend of $5/share gives the company a dividend yield of 2.6%.

In addition, MCD returns capital to shareholders through buybacks. Over the TTM period, MCD has repurchased $4.5 billion worth of shares, or 3.1% of its total market cap. MCD currently has $3.4 billion remaining on its current buyback authorization.

Insider Trading and Short Interest are Minimal

Over the past twelve months, insiders sold 345 thousand shares and did not purchase any shares. These share sales amount to less than 1% of shares outstanding.

There are currently 6.6 million shares sold short, which equates to less than 1% of shares outstanding and 2 days to cover. This minimal short interest indicates there is not much appetite to bet against the stock.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst[2] findings in McDonald's Corporation's 2018 10-K:

Income Statement: we made $2.4 billion of adjustments, with a net effect of removing $970 million in non-operating expense (5% of revenue). We removed $715 million in non-operating income and $1.7 billion in non-operating expenses. You can see all the adjustments made to MCD's income statement here.

Balance Sheet: we made $16.3 billion of adjustments to calculate invested capital with a net increase of $12.1 billion. The most notable adjustment was $8.8 billion in operating leases. This adjustment represented 30% of reported net assets. You can see all the adjustments made to MCD's balance sheet here.

Valuation: we made $44.7 billion of adjustments with a net effect of decreasing shareholder value by $43.2 billion. See all adjustments to MCD's valuation here.

Attractive Funds That Hold MCD

The following funds receive our Attractive-or-better rating and allocates significantly to McDonald's.

1. Fidelity Select Portfolios: Leisure Portfolio (FDLSX) – 23.1% allocation and Attractive rating
2. Direxion Daily Consumer Discretionary Bull 3x Shares (WANT) – 7.2% allocation and Very Attractive rating
3. Consumer Discretionary Select Sector SPDR Fund (XLY) – 7.2% allocation and Very Attractive rating

[2] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, style, or theme.

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Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

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- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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