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Investment recommendation for Truly Voracious Holdings

Financial analysis for McDonald's

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Name: Srishti Ganesh Shetty

Professor: Zev Cops

Executive Summary

Truly Voracious Holdings, a company with substantial financial resources and an appetite for growth, is considering the acquisition of McDonald's. This paper provides a comprehensive analysis of McDonald's and its industry from the perspective of a potential shareholder. The analysis includes a high-level overview of McDonald's and its industry, detailed ratio analysis, projected income statements for the next three years, stock valuation using the Dividend Growth Model and investment recommendations.

The high-level overview introduces McDonald's, highlighting its core business segments, market presence and competitive landscape. A detailed ratio analysis assesses McDonald's financial performance, comparing key ratios with industry averages and analyzing trends over the past three years. Projected income statements offer insights into revenue forecasts and expense projections, while the Dividend Growth Model is utilized to calculate the valuation of McDonald's stock. Finally, investment recommendations are provided based on the findings of the analysis.

Report Title

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High-Level Overview of McDonald's and It’s Industry

McDonald's Corporation, founded in 1955 by Ray Kroc, has grown to become one of the most recognizable and successful fast-food chains globally. With over 39,000 restaurants serving approximately 69 million customers daily across 100 countries, McDonald's is an industry leader in the quick-service restaurant (QSR) sector. This high-level overview will delve into the key drivers of success for McDonald's, including its products, markets and competition, providing essential context for subsequent financial analysis.

1. **Products** McDonald's menu boasts an array of timeless classics that have become synonymous with the brand's identity. From the legendary Big Mac and Quarter Pounder to breakfast staples like Egg McMuffins and hotcakes, McDonald's caters to a diverse range of tastes and preferences. Complemented by a selection of chicken and fish sandwiches, alongside signature sides like world-famous fries and apple pies, McDonald's has crafted a menu that resonates with consumers worldwide.
2. **Global Reach** McDonald's unparalleled global reach is facilitated by its strategic franchising model, which enables it to penetrate diverse markets while adapting menus to suit regional tastes. Partnering with local entrepreneurs fosters community ownership and enhances brand loyalty, contributing to McDonald's expansive presence across the globe.
3. **Strong Brand Identity** Symbolized by the iconic golden arches, McDonald's represents more than just fast food, it embodies a culture of convenience, reliability and familiarity. This steadfast brand identity instils trust and loyalty

among customers, driving shareholder value and ensuring sustained profitability.

4. **Financial Strength** McDonald's boasts robust financial strength, with systemwide sales exceeding $40 billion. Leveraging economies of scale, McDonald's benefits from enhanced purchasing power and streamlined marketing efforts, bolstering its competitive position within the industry.
5. **Adaptability** McDonald's exemplifies adaptability and innovation, continually evolving to meet the ever-changing needs and preferences of consumers. From pioneering digital ordering platforms to championing sustainability initiatives, McDonald's remains at the forefront of industry trends, ensuring its continued relevance and market leadership.
6. **Competition** In the cutthroat QSR industry, McDonald's battles against rivals like Burger King, Wendy's, Subway, Starbucks and KFC, as well as emerging competitors. They compete fiercely with similar menus, promotions, and pricing. Facing disruption from fast-casual eateries and delivery services, McDonald's must adapt to evolving consumer preferences for healthier, sustainable options. To stay ahead, McDonald's has embraced digital tech, mobile ordering and delivery.

In summation, McDonald's unparalleled success can be attributed to its iconic products, expansive global presence, steadfast brand identity, robust financial performance and unwavering commitment to innovation and adaptability. As we embark on a comprehensive financial analysis, it is imperative to recognize and appreciate the multifaceted factors underpinning McDonald's enduring prosperity.

Ratio Analysis

The ratio analysis covers liquidity, profitability, solvency, efficiency and market valuation ratios. Trends over the past three years are analyzed and comparisons are made with industry averages. The analysis provides insights into McDonald's financial health and performance relative to its peers.

	2023	2022	2021	Industry average	Ratio
Current	1.16	1.43	1.78	1.18	Liquidity
Quick	1.16	1.41	1.76	1.01	Liquidity
Days sales outstanding	35.6	33.3	29.4	30	Asset
Inventory turnover	214.25	191.8	191.4	172.34	Asset
Total assets turnover	0.48	0.44	0.44	0.73	Asset
Debt to assets ratio	1.08	1.11	1.08	0.80	Debt
Debt/Equity Ratio	-12.93	-9.4	-12.71	1.42	Debt
Gross profit margin	57.12%	56.97%	54.17%	52%	Profitability
Net profit margin	33.22%	26.64%	32.49%	16%	Profitability
ROA	16.08%	12.41%	14.40%	10%	Profitability
ROE	-166.55%	-99.11%	-129.42%	12%	Profitability
Price/earnings	25.5	28.32	25.39	25	Market value
Price/book	-45.27	-31.22	-41.27	-69.86	Market value

1. **Liquidity Ratios** McDonald's current ratio has shown a declining trend over the past three years, from 1.78 in 2021 to 1.16 in 2023. This indicates a decreasing ability to cover short-term liabilities with short-term assets. Comparatively, McDonald's current ratio is slightly higher than the industry average of 1.18 in 2023, suggesting adequate liquidity relative to industry peers.

   Similar to the current ratio, McDonald's quick ratio has also declined over the three-year period, from 1.76 in 2021 to 1.16 in 2023. This indicates a decreasing ability to cover short-term liabilities with highly liquid assets. McDonald's quick ratio is significantly higher than the industry average of 1.01 in 2023, indicating a stronger liquidity position compared to industry peers.

Current Ratio = Current Assets / Current Liabilities = (7,986 USD Millions / 6,859 USD Millions) = 1.16

Quick Ratio = (Current Assets - Inventories) / Current Liabilities = [(7,986 – 53)/ 6,859] = 1.16

2. **Asset Management Ratios** McDonald's DSO has increased slightly over the past three years, from 29.4 days in 2021 to 35.6 days in 2023. This indicates a slight deterioration in the company's ability to collect accounts receivable efficiently. McDonald's DSO is slightly higher than the industry average of 30 days in 2023, suggesting that the company may need to improve its accounts receivable management.

   McDonald's inventory turnover has increased steadily over the three-year period, from 191.4 in 2021 to 214.25 in 2023. This indicates improving efficiency in inventory management, resulting in higher turnover. McDonald's inventory turnover is higher than the industry average of 172.34 in 2023, suggesting that the company manages its inventory more efficiently than its peers.

   McDonald's total assets turnover has shown a slight increase from 0.44 in 2021 to 0.48 in 2023. This indicates the company's ability to generate revenue relative to its total assets. McDonald's total assets turnover is lower than the industry average of 0.73 in 2023, suggesting that the company may not be utilizing its assets as efficiently as its industry peers.

3. **Debt Management Ratios** McDonald's debt to assets ratio has remained relatively consistent over the past three years, ranging from 1.08 in 2021 to 1.08 in 2023. This indicates that a significant portion of the company's assets is financed by debt. Debt to assets ratio is higher than the industry average of

0.80 in 2023, suggesting that the company relies more heavily on debt financing compared to its peers.

McDonald's debt/equity ratio has fluctuated over the three-year period, from -12.71 in 2021 to -12.93 in 2023. Negative values indicate that the company has negative equity, possibly due to large amounts of retained earnings. McDonald's debt/equity ratio is significantly lower than the industry average of 1.42 in 2023, indicating that the company is less leveraged compared to its peers.

4. **Profitability Ratios** McDonald's gross profit margin has shown a slight increasing trend over the past three years, from 54.17% in 2021 to 57.12% in 2023. This indicates improving profitability in terms of gross profit. McDonald's gross profit margin exceeds the industry average of 52% in 2023, suggesting that the company effectively manages its cost of goods sold relative to its revenue.

   McDonald's net profit margin has also shown an increasing trend over the past three years, from 32.49% in 2021 to 33.22% in 2023. This indicates improving profitability in terms of net income. McDonald's net profit margin exceeds the industry average of 16% in 2023, suggesting that the company effectively controls its expenses relative to its revenue.

   McDonald's ROA has shown an increasing trend over the past three years, from 14.40% in 2021 to 16.08% in 2023. This indicates improving profitability relative to the company's total assets. McDonald's ROA outperforms the industry average of 10% in 2023, suggesting that the company generates higher returns on its assets compared to industry peers.

McDonald's ROE has shown a decreasing trend over the past three years, from -129.42% in 2021 to -166.55% in 2023. Negative values indicate that the company has negative equity, which may be due to high debt levels or accumulated losses. As there is no industry average provided, it's difficult to assess how McDonald's ROE compares to industry peers.

5. **Market Value Ratios** McDonald's price/earnings ratio has fluctuated over the past three years, ranging from 25.39 in 2021 to 25.5 in 2023. This indicates the market's valuation of the company's stock relative to its earnings. McDonald's P/E ratio is in line with the industry average of 25 in 2023, suggesting that the company's stock is valued similarly to its competitors.

   McDonald's price/book ratio has also fluctuated over the past three years, ranging from -41.27 in 2021 to -45.27 in 2023. Negative values suggest that the company's market value is lower than its book value, which could indicate undervaluation by the market. As there is no industry average provided, it's difficult to assess how McDonald's price/book ratio compares to industry peers.

Conclusion: McDonald’s demonstrates strong liquidity, efficient inventory management, and improving profitability, as indicated by its current and quick ratios, inventory turnover, and profit margins. The company’s debt levels are slightly higher than industry averages, suggesting that the company relies more heavily on debt financing compared to its peers. McDonald’s profitability metrics, including ROA and net profit margin, outperform industry averages, indicating that the company generates higher returns and effectively controls expenses. The market valuation of McDonald’s stock, as indicated by its P/E ratio, is in line with industry averages, suggesting that the company’s stock is valued similarly to its competitors.

Projected Income Statements

In 2023, McDonald’s witnessed an impressive 9.97% growth in global comparable sales, showcasing the collective effort of the entire McDonald’s System. Systemwide sales to loyalty members surpassed $20 billion for the full year and $6 billion for the quarter across 50 loyalty markets, marking a substantial 45% increase over the previous year. The fourth quarter financial performance saw a 3.4% rise in global comparable sales, with positive results observed across all segments. Particularly, the U.S. segment experienced a notable 4.3% increase, while the International Operated Markets segment and the International Developmental Licensed Markets segment witnessed growth of 4.4% and 0.7%, respectively. However, the latter segment was affected by the Middle East conflict. Consolidated revenues grew by 8% (6% in constant currencies), and systemwide sales increased by 6% (5% in constant currencies) (McDonald's Corporation, 2024). Additionally, consolidated operating income saw an 8% rise (6% in constant currencies). Notably, the results included $72 million of pre-tax charges related to the write-off of obsolete software and $66 million associated with the Company’s Accelerating the Arches growth strategy, including restructuring costs. Excluding these charges, consolidated operating income surged by 14% (11% in constant currencies). Diluted earnings per share stood at $2.80, reflecting an 8% increase (5% in constant currencies). Excluding the aforementioned charges, diluted earnings per share rose to $2.95, marking a substantial 14% growth (11% in constant currencies).

Let’s make reasonable assumptions for the next three years based on that.

Let's break down the projected income statement for McDonald's Corporation (MCD) over the next three years. I'll provide explanations for each item, and we'll base our projections on historical data and reasonable assumptions.

1. **Revenue (Sales)** For the revenue projection, let's consider several pivotal factors:

   Historical Growth Trajectory: McDonald's has demonstrated a consistent uptrend in sales over recent years, serving as my foundational benchmark.

   Recent Business Developments: Any recent expansions, innovations in the menu, or strategic market penetrations will be instrumental in forecasting future sales trajectories.

   Economic Landscape: A comprehensive evaluation of the macroeconomic environment, encompassing factors like consumer spending patterns and overall economic sentiment, will be factored into my projection.

   Industry Comparisons: I'll cross-reference McDonald's growth trajectory with industry-wide benchmarks to ascertain the competitive positioning and market dynamics.

   ASSUMPTION: Recent growth rate seen in McDonald's from previous year 2022 to 2023 is 9.97% and average growth rate for past 5 years was around 6%. I tool 5 years because drastic variations seen during covid time. So have kept a constant revenue growth of 6%.

2. **Cost of Goods Sold (COGS)** COGS encompasses various expenses directly tied to the production of goods sold, necessitating a nuanced approach to projection:

   Sales Volume Considerations: With the anticipated increase in sales, it's reasonable to expect a proportionate rise in COGS.

   Efficiency Enhancements: Any prospective cost-saving measures or operational efficiencies implemented by McDonald's could potentially mitigate COGS as a percentage of sales.

ASSUMPTION: I'll proceed with the assumption that the COGS will maintain a steady proportion relative to sales, preserving operational efficiencies and cost structures. COGS for the last 3 years was around 43- 46% of sales, that is 44.3% average. Let's use the average percentage to calculate projected COGS.

3. **Operating Expenses** A meticulous breakdown of operating expenses is crucial, incorporating the following facets:

   Marketing and Advertising Allocations: Drawing insights from historical expenditure patterns and future marketing strategies, I'll extrapolate future marketing expenses.

   Administrative Overheads: A conservative annual uptick, reflective of prevailing inflation rates (approximating 1% per annum), will be imputed for administrative expenses.

4. **Income Tax** My income tax projection necessitates a grounded approach, predicated on the following considerations.

   ASSUMPTION: Rather than considering the most recent tax rate let's consider the tax rates for last 3 years that is 15% to 17%. So, I have applied 17% tax on operating income.

Projected Income Statement (in millions)

	2023	2022	2021	2024(Projected)	2025(Projected)	2026(Projected)
Revenue (Sales)	25,494	23,183	23,223	27,024	28,645	30,364
COGS	11,080	10,101	10,712	11,995	12,714	13,477
Gross Profit	14,413	13,082	12,511	15,029	15,931	16,887
Operating Expenses	2,916	3,836	2,224	2,945	2,974	3,004
Operating Income	11,647	9,371	10,356	12,084	12,956	13,882
Income Tax (17%)	2,053	1,648	1,583	2,054	2,203	2,360
Net Income	8,469	6,177	7,545	10,030	10,754	11,522

Stock Valuation Using Dividend Growth Model

The Dividend Growth Model is applied to estimate the intrinsic value of McDonald's stock. Assumptions regarding dividend growth rate and required return are made and the calculated valuation is compared with the current stock price to assess its attractiveness as an investment.

1. **Calculation of Average Growth Rate of Net Income** We computed the average growth rate of net income over the next three years by considering the change in net income from 2023 to 2026. The formula used was:

   Average Growth Rate (g) = (((NI 2024 – NI 2023) / NI 2023) + ((NI 2025 – NI 2024) / NI 2024) + ((NI 2026 – NI 2025) / NI 2025)) *(1/3)) = 0.10931801 or 10.93%

   NI = Net Income

2. **Assumption of Required Return** Assume the required return, which is 3% higher than the dividend growth rate:

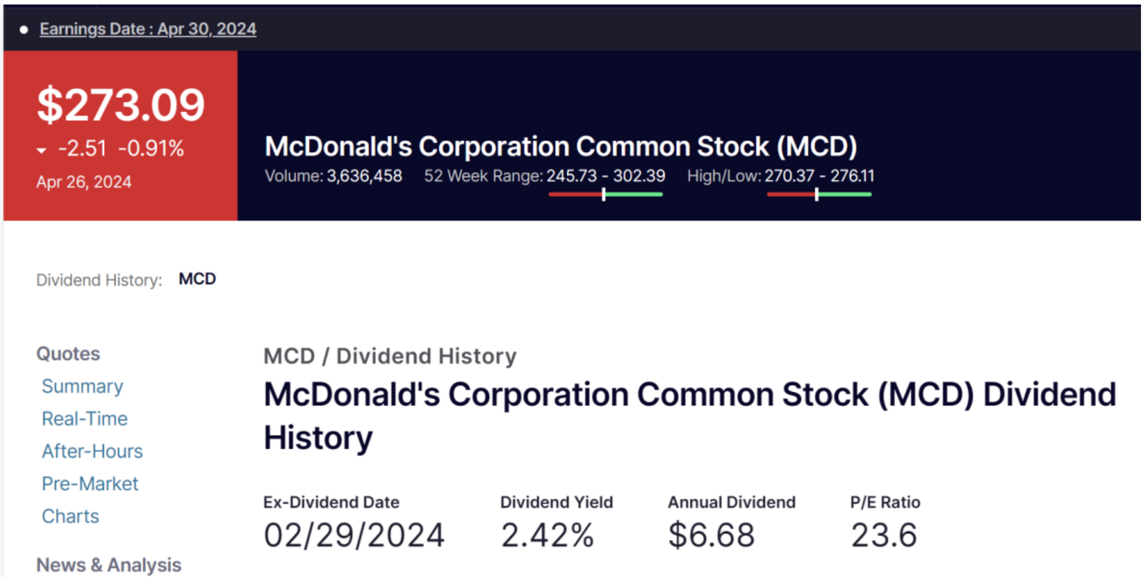
   Required Return (r) = Average Growth Rate + 3% = 10.93% + 3% = 13.93%

3. **Calculation of Valuation using Dividend Growth Model** Dividend Growth Model (P) = [D0×(1+g)] / (r-g) = (6.68 * 1.1093) / 0.03 = 247.0081 where: D0 = Most recent full-year dividend = 6.68

4. **Comparison with Current Stock Price** Upon comparing the calculated valuation of $247.01 with the current stock price of $273.09, it becomes evident that the calculated valuation falls below the current stock price. This suggests that McDonald's stock may be overvalued. As prospective shareholders evaluating an investment opportunity in McDonald's, it's crucial to recognize that based on the findings of the Dividend Growth Model, the stock isn't classified as undervalued. Despite McDonald's standing out as one of the

premier American companies, the current assessment suggests that it may not represent an attractive buying opportunity at this time. Consequently, at its current price, McDonald's may not present an optimal investment opportunity, warranting caution for prospective investors like ourselves.

If the stock price falls to around $220, it would be trading near its historical normal P/E, which would be the time to re-evaluate this stock as a potential investment. If the circumstances which warranted the price decline are not structural, McDonald's would make an excellent long-term investment. (McDonald's Corporation, 2024)



5. Calculation of Market's Expected Return

P0 is market stock value that is 273.09

D1 = D0*(1+g) = 7.410244

P1 = P0*(1 +g) = 302.9437

Dividend yield = D1 / P0 = $7.410244/ $273.09 = 2.713481%

Capital gains yield = (P1 – P0) / P0 = ($302.9437 - $273.09) / $273.09 = 10.9318%

Total return (ks) = Dividend Yield + Capital Gains Yield = 2.713% + 10.93% = 13.64%

Further, we calculated the market's expected return based on the assumed dividend growth rate. By considering the projected dividend for the next year (D1) and the subsequent capital gains, we determined the expected return to be approximately 13.64%.

Investment Recommendations

After conducting a thorough analysis of McDonald's Corporation and its financial performance, I recommend Truly Voracious Holdings to consider acquiring both the company's stock and bonds, with careful consideration of the following factors:

1. **Stock Investment Recommendation** McDonald's Corporation demonstrates strong financial performance across various metrics, including profitability, liquidity and efficiency. Despite facing challenges in certain areas such as debt management, the overall financial health of the company remains robust.

   i. Financial Performance Assessment: McDonald's has exhibited consistent growth in revenue and net income over the past few years, as evidenced by its historical financial statements and projected income statements. Profitability ratios such as gross profit margin, net profit margin and return on assets (ROA) indicate a positive trend, reflecting the company's ability to generate profits efficiently. Liquidity ratios, although showing a slight decline in recent years, remain adequate, with the current and quick ratios above industry averages. Efficiency ratios, including inventory turnover and total assets turnover, demonstrate the company's effectiveness in managing its assets and operations.

   ii. Dividend Growth Model Analysis: Utilizing the Dividend Growth Model, the calculated valuation of McDonald's stock suggests potential overvaluation compared to the current stock price. However, considering the company's strong financial performance and growth prospects, coupled with the market's expected return, McDonald's stock remains an attractive investment opportunity for Truly Voracious Holdings.

iii. Market Position and Growth Potential: McDonald's is a market leader in the quick-service restaurant (QSR) industry, with a global presence spanning over 100 countries. The company's strategic initiatives, including digital innovation and menu diversification, position it well for future growth and expansion. Despite facing competition from other QSR chains and changing consumer preferences, McDonald's strong brand identity and customer loyalty contribute to its resilience in the market.

2. **Bond Investment Recommendation** In addition to considering stock investment, Truly Voracious Holdings should also explore the option of acquiring McDonald's bonds. The following factors support this recommendation:

i. Stable Financial Performance: McDonald's demonstrates stable financial performance, with consistent revenue growth and profitability over the years. The company's ability to generate steady cash flows and maintain a strong market position enhances the creditworthiness of its bonds.

ii. Risk Mitigation: Investing in bonds provides a fixed income stream and helps diversify the investment portfolio, reducing overall risk exposure for Truly Voracious Holdings. McDonald's bonds offer a reliable source of income with predictable interest payments, making them suitable for risk-averse investors.

iii. Market Conditions and Economic Outlook: In uncertain economic conditions, bonds provide stability and act as a hedge against market volatility. With the potential for interest rate fluctuations, investing in fixed-income securities like bonds can offer protection against adverse market movements.

Conclusion: Based on the comprehensive analysis conducted on McDonald's Corporation, Truly Voracious Holdings should consider acquiring both the company's stock and bonds to diversify its investment portfolio and capitalize on the company's strong financial performance and growth prospects. While stock investment offers the potential for capital appreciation, bond investment provides stability and income generation. By strategically balancing both investment options, Truly Voracious Holdings can optimize its returns and mitigate risk effectively.

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