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Erasmus Platform for Sustainable Value Creation

Case study
McDonald's

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RSM *Erasmus*

McDonald's:
a sustainable finance case study

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Important: this company analysis was done for educational purposes. It is not an investment recommendation nor does it in any way reflect the opinion of RSM, Erasmus University. Target prices were calculated only to illustrate ways of thinking about value.

1 Abstract

This is the third[1] in a series of RSM case studies on sustainable finance. Using a list of questions, we show how to integrate sustainability into investment analysis by connecting sustainability to business models, competitive position, strategy and value drivers. Here the questions are answered for McDonald's, a company that faces substantial sustainability challenges, on both the social (health) and environmental (footprint) dimensions. Our findings suggest that McDonald's is not as well positioned as Philips, but much better than Air France-KLM. Unlike the latter, McDonald's does have significant options to deal with its sustainability issues. However, our ability to properly assess its transition preparedness is hampered due to the absence of essential data: McDonald's sustainability reporting is limited and lacks targets and numbers. Unfortunately, this is typical of current reporting practices.

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[1] After Philips (https://www.rsm.nl/fileadmin/Images_NEW/Erasmus_Platform_for_Sustainable_Value_Creation/Case_Study_Sustainable_Finance_Royal_Philips.pdf) and Air France-KLM (https://www.rsm.nl/fileadmin/Images_NEW/Erasmus_Platform_for_Sustainable_Value_Creation/Case_study_KLM_01.pdf)

2 Introduction

In this case study we analyse McDonald's, a company that faces substantial sustainability headwinds.

We chose McDonald's because it highlights the predicament of a company that performs very well financially as long as its negative externalities are not internalized. Like the other cases in this series (on Philips and Air France-KLM), it presents a list of questions that allow analysts to integrate sustainability into investment analysis by connecting sustainability to business models, competitive position, strategy and value drivers.

Our finding suggest that McDonald's is not as well positioned as Philips to meet its sustainability challenges. Like Air France-KLM, McDonald's faces serious sustainability challenges both on the social (health) and environmental (carbon footprint) side. However, its odds of overcoming these headwinds look much better than at Air France-KLM: McDonald's is more profitable, more advanced in terms of sustainability reporting and thinking, and it has significant options to deal with these issues. For example, the company has taken initiatives to make its food healthier but encountered lukewarm consumer response; and its supply chain initiatives look promising, be it with the suspicion of green washing. However, it needs to be emphasized that essential data is missing as McDonald's sustainability reporting is limited and lacks targets and numbers. This puts a large question mark on the company's transition preparedness. Investor engagement could alleviate this problem.

Like the other cases in this series, this one highlights the need for fundamental analysis (that is, going well beyond ESG ratings) to properly assess a company's transition preparedness, which we deem the essence of corporate sustainability.

This article is set up as follows: in the next section, the list of questions is presented. In the subsequent section, the questions are answered for McDonald's, starting with the company's business model and value drivers, before diving into strategy and sustainability. It then goes back to the value drivers and the investment case to see how they have been affected by the sustainability analysis. In this way, the analyst develops a holistic view of the company. The final section concludes and reflects.

3 The list of questions

The below list of questions (Table 1) has been made over the course of several years of doing ESG integrated investment analysis, and is exactly the same as in the Philips case. More recently, they have been structured as an assignment for the Sustainable Finance course taught at Erasmus University and can be found in our Sustainable Finance textbook (Schoenmaker and Schramade, 2019, Chapter 8).

They are meant to deepen students' and practitioners' understanding of ESG integration by having them apply sustainable finance insights to a real life example – and ideally discuss with fellow students or colleagues. They are 25 questions (even more including sub-questions) in six sections. Although the six sections address different issues, it should become obvious during the analysis that they are very much related.

TABLE 1 *LIST OF SUSTAINABLE FINANCE QUESTIONS FOR ESG INTEGRATION*

Section	Questions
1. Business model & competitive position	1.How would you describe the company's business model? 2.How strong do you rate the company's competitive position? 3.What trends affect the company's business model and competitive position?
2. Value drivers (part 1)	1.Sales growth: what seems to be a normal sales growth for the company? And what are the drivers of sales growth? 2.Margins: what seems to be a normal profit margin (EBIT or EBITDA) for the company? And what are the drivers of that margin? 3.Capital: how capital intense is the company? What do you think is the firm's cost of capital? What is the firm's return on invested capital (ROIC) 4.Please sketch how you see the company's value drivers going forward?

3. Sustainability	**1.**Purpose: what is the company's mission / purpose / raison d'être? In what way does the company create value for society? How does it get paid for that value creation?
	2.Stakeholders: what are the company's main stakeholders? Please fill out the stakeholder impact tool
	3.Externalities & impact: Does the company generate serious externalities? Are they positive or negative? How do you assess the chances of these externalities to be internalized? Thresholds: how does the company perform versus the planetary boundaries?
	4.SDGs: which of the SDGs (if any) does the company help achieve? Which negative SDG exposures (if any) does the company have?
	5.Impact: to what extent can the company's impact be measured? Does the company report on its impact? How can its impact reporting be improved?
	6.Material issues: what are the most material ESG factors? I.e., what issues are most critical to the success of the company's business model? Please fill out the given matrix, discussing for each of these most material ESG factors (1) how the company performs on it; (2) whether the company derives a competitive (dis)advantage from it; (3) how they might affect the value drivers
	7.Sustainability reporting: how do you assess the company's non-financial reporting? Does the company (claim to) do Integrated Reporting (<IR>)? To what extent do you see the seven principles of <IR> reflected in the company's reporting?
4. Strategy	**1.**How would you describe the strategy of the company?
	2.To what extent does that strategy take into account the company's most material ESG issues? Please link to your answer in the sustainability section.
	3.Is the strategy consistent with the company's purpose?
	4.What does long-term value creation look like? What are the best KPIs for it?
	5.What does management compensation look like? To what extent does management have long-term incentives? And are those incentives aligned with long term-value creation?
	6.How does the company communicate its long-term value creation with shareholders and stakeholders?
5. Value drivers (part 2)	**1.**Given all of the above questions & their answers, how do you rate the effect of material sustainability issues on the value drivers going forward? Per value driver, please indicate whether you see a positive, negative or neutral effect
	2.How would this affect your valuation of the company?

6. Investment conclusions

1. How well prepared do you think McDonald's is for the transition to a more sustainable economic model?

2. How attractive do you find the company as an investment?

3. What did you find most surprising when answering the above questions?

4. If you were to engage with the firm, what topics would you address?

Source: authors

Of course, these questions can be answered either very high level or in a very detailed way. And not all questions will need to be answered every time or right away. Ideally, priorities will depend on the needs of the user and the relevance of the particular issue in the context at hand. It certainly should not be a matter of perfectionism or box-ticking, as answering the questions is not a goal in itself but meant to build a good holistic understanding of a company's transition preparedness and investment attractiveness.

4 Answering the questions for McDonald's

In this section, the questions are answered for McDonald's. We answered the questions based on publicly available material. Ideally, the answers serve as a useful illustration and help answering the same or similar questions for different companies as well.

1. Business model & competitive position

See Chapter 5 of Schoenmaker and Schramade (2019) for a description of the below concepts and how they relate to each other.

Business model & competitive position

1.1. How would you describe the company's business model? What are its customer value proposition and profit formula?[2]

McDonald's is the world's largest restaurant chain with 36,000 stores in over 100 countries. The vast majority (>90%) of these stores are run as franchises. As they say it[3]: "The power of our franchisees, suppliers and employees working together toward a common goal is what makes McDonald's the world's leading quick-service restaurant brand". And McDonald's founder Ken Croc defined its value proposition in this way: "McDonalds stands for friendliness, cleanliness, consistency, and convenience".

The company essentially has two profit formulas:

- One for the restaurants the company owns, where it gets all revenues and bears all costs;

- And one for the franchised restaurants, where it gets rent payments, and royalty fees that depend on a percentage of the franchisees' sales.

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[2] Johnson *et al.* (2008) argue that a successful business model has three components:
> **1.** the model helps customers perform a specific 'job' that alternative offerings do not address;
> **2.** the model generates value for the company through factors such as the revenue model, cost structure, margins and/or inventory turnover;

Key resources and processes: the company has the people, technology, products, facilities, equipment and brand required to deliver the value proposition to targeted customers. The company also has processes (training, manufacturing, services) to leverage those resources.

[3] https://corporate.mcdonalds.com/corpmcd/about-us/our-business-model.html

At the latter, the company's revenues are lower, but its margins are much higher. Although franchised restaurants remain independent and manage their day-to day operations themselves, McDonald's supervises them and controls the quality of food and services. In company-owned restaurants, McDonald's develops and tests innovations, improve operations and pricing, and train employees. McDonald's owns the land and buildings (or has long-term financial leases), so that it has a greater control over franchises and a source of additional income. McDonald's subleases restaurants with a 40% mark-up.

1.2. How strong do you rate the company's competitive position?

McDonald's enjoys a strong competitive position in the Informal Eating Out segment (IEO) versus peers such as Burger King and KFC. Its major strength is its network: franchises, landowners, and supply chain. The franchise model allows McDonald's to expand without overcomplicating the management system. McDonald's focuses on the development of the brand by setting standards for the food chain, doing market research and advertisement. Moreover, the model preserves incentives for managers of restaurants, who are at the same time self-employers. The model also allows McDonald's to serve locally relevant food because restaurants are run by local entrepreneurs who are familiar with regional food preferences.

The company's position is not undisputed however, and the market has become more blurred with the competition from new entrants: online delivery platforms and convenience and grocery stores.

1.3. What trends affect the company's business model and competitive position?

Several trends can be identified:

- Urbanization and a growing middle class in emerging markets drive demand for meat[4] and fast food restaurants – a clear positive for McDonald's

- Digitalization. Customers have become more used to technological innovations and require higher quality services. Greater customer experience can be achieved through digitalization of delivery and services in the restaurants. Moreover, digitalization can reduce costs and optimize the control over the supply chain – an opportunity for McDonald's to further expand its scale advantage over competitors, but also a threat from online delivery companies.

- Increasing health awareness due to the surge in chronic diseases like diabetes - a threat for McDonald's

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[4] Global meat production grew almost 2% per year over the past decade and is expected to grow by 1% per year over the next decade (FAO, 2018, "Transforming the livestock sector through the Sustainable Development Goals")

- Climate change mitigation measures will likely put limits on the growth of meat production – a threat for McDonald's

So, a mixed picture emerges as the first two trends are positives for McDonald's, and the latter two are negatives.

2. Value drivers - part 1

Sales growth

2.1. What seems to be a normal sales growth for the company? Please explain. And what are the drivers of sales growth?

Optically, sales growth turned negative in 2014. However, this was driven by a deliberate strategy to reduce the number of restaurants owned in favor of franchisees, which makes the business model more asset light. The company's target is to achieve a comparable sales growth of 3-5%. The main drivers are the number of customers and the average value of the bill.

Margins

2.2. What seems to be a normal profit margin (EBIT or EBITDA) for the company? Please explain. And what are the drivers of that margin?

McDonald's has a history of high margins (around 30% EBIT margin), and in recent years margins have gone even higher (over 40%). This was driven by the increasing proportion of franchised (80% margin) vs owned restaurants (17% margin). That is not without risk though as franchisees might stop accepting high fees.

Underlying drivers of margins include comparable sales and occupancy costs, the size of royalties as % of revenue, and the currency translations effects for franchise sales. For company-operated margins the main drivers are comparable revenues, commodity prices, personnel costs, and VAT.

Capital

2.3. How capital intense is the company?

By end 2018, McDonald's had $32.8 billion in assets and $29.8 billion invested capital (IC)[5]. With sales of $21.0 billion, the firm's capital intensity (IC/sales) is 1.4. This is higher than at the typical company and similar to the 1.5 we see at an aluminum company. However, McDonald's has much higher margins than the latter and hence has much higher ROIC.

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[5] Invested capital deviates from total assets as non-operating assets (such as stakes and excess cash) and non-interest bearing short term liabilities are deducted from total assets to arrive at invested capital.

2.4. What do you think is the firm's cost of capital? Please explain

McDonald's' levered beta is 0.68 on a 5 year monthly basis. Due to its leverage (Net debt/Equity[6]=30/136=0.22), its unlevered beta is even lower, at 0.56 (0.68/1.22=0.56). As its beta is well below 1, McDonald's can be considered a defensive stock.

Assuming a long-term risk-free rate (Rf) of 4% and long-term market expected return (Rm) of 8%, its WACC becomes: 4%+0.56*(8%-4%)=6.2%.

2.5. What is the firm's return on invested capital (ROIC)? Please explain

With 2018 NOPLAT[7] at $6.3bn, McDonald's has ROIC=NOPLAT/IC=6.3/29.8=21%. This is quite high, well above the company's cost of capital of 6.2%. However, it remains to be seen if the company can sustain such levels in the future.

Value driver overview

2.6. Please sketch how you see the company's value drivers going forward in the table below

TABLE 2: *VALUE DRIVER ASSESSMENT FOR MCDONALD'S*

Value driver	Market implied per 4 June 2019	Extrapolation of the 2021 expectations	Our assessment for the next decade, before ESG analysis	Our assessment for the next decade, after ESG analysis
Sales growth	4%	4%	3%	2%
EBIT margins	44%	47%	43%	40%
WACC	6.2%	6.2%	6.2%	7%
Resulting fair value	$199	$219	$184	$129

Source: athors' analysis[8]

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[6] Source: Bloomberg

[7] NOPLAT=Net operating profit less adjusted taxes. See for example Koller et al. (2015).

[8] Market implied per 4 June 2019 sales growth in line with management guidance of 3-5%

The market seems to price in 4% sales growth (i.e. in the middle of company guidance), while maintaining the 44% EBIT margins at a 6.2% WACC. Extrapolation of the expectations for 2021 (i.e. 47% margins) gives a 10% higher stock price ($219).

Even before doing our ESG integrated analysis, we were skeptical of McDonald's ability to keep on growing and expanding margins, resulting in a fair value assessment of $184 (5% downside to the $199 share price on 4 June 2019). As we will explain later, our ESG integrated analysis resulted in negative growth and falling (but still high) margins, and a fair stock price of $129, i.e. 34% lower than the price at the time of writing. This suggests that risk is much higher than widely perceived.

3. Sustainability

Purpose

3.1. What is the company's purpose / raison d'être? In what way does the company create value for society? How does it get paid for that value creation?

McDonald's aims to be its customers' favorite place and way to eat and drink (Mission statement 2013). Along with its Customer Value Proposition, this implies value creation for society in terms of affordability and convenience. In addition, the company advertises four corporate values[9]: responsible leadership; inclusiveness; progressiveness; and local integration. However, it can be argued that the company also destroys value for society due to the negative health and environmental effects of its products. Still, the company operates a very successful profit formula (see value driver section above).

Stakeholders

3.2. What are the company's main stakeholders? Please fill out below the stakeholder impact tool

On its corporate website, McDonald's mentions an impressive list of initiatives where it engaged its stakeholders[10], including its participation in roundtables on palm oil and sustainable beef. However, we could not find a list or mapping of

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[9] https://corporate.mcdonalds.com/corpmcd/about-us/our-values.html

[10] https://corporate.mcdonalds.com/corpmcd/scale-for-good/using-our-scale-for-good/engaging-stakeholders.html

stakeholders that allows for a structured analysis and overview. In that end, using a stakeholder impact map is very useful.

TABLE 3: *STAKEHOLDER IMPACT MAP FOR MCDONALD'S*

	Employees	Franchisees	Suppliers	Customers	Society & government
Long-term goals	Good work-life balance and salaries; Personal development, professional pride & financial/job security	Profits	Good prices, stability	Cheap, healthy, tasty, convenient, fast food	Healthy population, low environmental footprint & high tax income
How the company helps those goals	Pay and job fulfilment	Brand, supply chain, digital innovation	Long-term contracts	Low prices, initiatives for healthier products	Paying taxes, efforts to reduce its footprint
How the company hurts those goals	Demanding work environment; long hours; low pay?	Fees paid, tight control system	Switching, hold-up problems	Unhealthy, slow, smelly	Unhealthy food, high carbon footprint, poor pay (including lobbying against US minimum wage)

Source: authors' analysis

Just like in the Air France-KLM case, the McDonald's stakeholder impact map shows serious frictions between what stakeholders want and what they get:
• Customers: healthy versus tasty & cheap
• Employees: low pay
• Society: high carbon footprint & health issues

These frictions stand in stark contrast to the Philips case, where the stakeholder impact map found very limited friction among stakeholders. Most companies seem to be in between, with less but still significant frictions among stakeholders. We find it educationally rewarding to discuss stakeholder impact maps and their frictions in a group. Our teaching sessions showed that, with a bit of help, a group of students can get to the core of such issues very fast.

Externalities & impact

To guide the transition towards a sustainable and inclusive economy, the United Nations has developed the 2030 Agenda for Sustainable Development. The 17 UN Sustainable Development Goals (SDGs) stimulate action over the years 2015-2030 in areas of critical importance for humanity and the planet. This should result in a serious reduction in negative externalities. The corporate sector too is increasingly working on the internalisation of externalities, which is a threat for some and an opportunity for others (e.g., Schramade, 2017). However, even if the SDGs are achieved, that does not guarantee that we stay within the planetary boundaries identified by Steffen et al. (2015) – beyond which climate may change so dramatically that life on earth becomes hard if not impossible.

3.3. Does the company generate serious externalities? Are they positive or negative? How do you assess the chances of these externalities to be internalised?

McDonald's produces two seriously negative externalities:

1. Negative health effects;
2. Negative environmental effects.

Both these effects help make McDonald's (meat) products artificially cheap, which is not a sustainable situation.

NEGATIVE HEALTH EFFECTS

McDonald's is famous for its burgers and fries, but such food is unhealthy, adding to unbalanced diets and high rates of obesity and diabetes – which are on the rise globally. Moreover, the use of antibiotics makes meat cheaper to produce but also even more unhealthy for consumers. The latter is now being addressed as McDonald's recently announced a plan to reduce the use of antibiotics in its supply chain[11]. However, even after the removal of antibiotics, most of McDonald's products are still unhealthy. That externality is likely to be internalized in two ways.

First, consumer awareness of unhealthy eating habits is on the rise, with rising demand for healthier food in developed markets. So far, however, the impact on McDonald's has been small as such awareness is mostly limited to a subset of consumers that isn't part of the company's core customer base. In fact, the company's experiments with healthier food have large been unsuccessful for that very reason. Those experiments though, do show that McDonald's has significant optionality to deal with this threat. The same applies to the emergence of suppliers of meatless burgers, such as Beyond Meat, which recently made successful stock market entries.

The second way for this externality to be internalized is regulation. Governments might impose stricter requirements on the nutritional value of food quality, or even levy taxes on salt, fat and sugar. Such measures would lead to higher input

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[11] https://www.dairyherd.com/article/mcdonalds-announces-antibiotic-policy-beef

prices for McDonald's, and force the company to raise its own prices as well. This would threaten the affordability of its products, a core component of its customer value proposition and business model.

NEGATIVE ENVIRONMENTAL EFFECTS
McDonald's produces large negative environmental effects, due to its extensive use of packaging (often plastics) and the deforestation and carbon emissions that result from the meat it uses.

The packaging problem in particular is being tackled. In 2018, McDonald's announced that by 2025, all of its packaging should come from renewable, recycled or certified sustainable sources[12]. In addition, the company aims to recycle guest packaging in 100% of McDonald's restaurants (versus circa 10% in 2018) – while admitting that "recycling infrastructure, regulations and consumer behaviors vary from city to city and country to country, but we plan to be part of the solution and help influence powerful change"[13].

Meat, especially beef, has a large carbon footprint, and meeting growing meat demand is not achievable within Planetary Boundaries (FAIRR, 2019[14]). An analysis by TrueValue Labs[15] suggests that McDonald's significantly underreports on its carbon footprint. And deforestation is also a serious issue in McDonald's supply chain, not just in meat but in soy too. This suggests that the health effects might be easier to solve than the environmental effects.

3.4. Which of the SDG's (if any) does the company help achieve? Which negative SDG-exposure (if any) does the company have?

Given the above mentioned negative externalities, McDonald's has quite negative exposures to SDGs 3 (health & well-being), 12 (sustainable production and consumption), 13 (climate action), 14 (life below water), and 15 (life on land). The company paints a different picture though. It dedicates a separate part of its website to its contributions to the SDGs[16], but focuses squarely on how the company can make a positive contribution. There is no mention of its negative exposures, which is awkward, and undercuts the credibility of its commitments. Table 4 outlines how McDonald's believes it makes a positive impact on 6 of the 17 SDGs.

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[12] http://www.climateaction.org/news/all-mcdonalds-packaging-will-be-sustainable-by-2025

[13] https://corporate.mcdonalds.com/corpmcd/scale-for-good/packaging-and-recycling.html

[14] FAIRR, 2019, Managing environmental risks in meat and dairy supply chains

[15] TrueValue Labs, January 2019, Research Brief McDonald's Corporation

[16] https://corporate.mcdonalds.com/corpmcd/scale-for-good/using-our-scale-for-good/un-sustainable-development-goals.html

TABLE 4: SDG CONTRIBUTION CLAIMS BY MCDONALD'S

SDG	Contributing to..	Credibility	Explanation
2. Zero hunger	Universal access to safe and nutritious food	Low	Its food is cheap, but not that cheap that it feeds people who are starving; yes it's safe, but not very nutritious
8. Decent work & economic growth	Reducing unemployment and developing useful skills	Medium	Does offer opportunities, but at low wages
12. Responsible production and consumption	Sourcing food and packing responsibly	Medium	So far negative, but serious initiatives being taken
13. Climate action	Help reduce climate change impact	Low	Very negative footprint from meat and seems to be lower priority than packaging
15. Life on land	Eliminate deforestation from its supply chain	Medium	This could result in a serious reduction of a negative impact. And the company has strong incentives to reduce risk here.
17. Partnerships for the goals	Partner with stakeholders to tackle global issues	Low	How serious is the company on the above?

Source: authors' analysis

There are clearly areas where McDonald's can make a significant contribution, and such efforts should be applauded. But it is mostly about making negative impact less negative – and with mixed levels of credibility and commitment. By its sole attention to positives, McDonald's makes this look like corporate propaganda and SDG-washing. This also raises the question of how they spend their lobbying money.

3.5. To what extent can the company's impact be measured? Does the company report on its impact? How can its reporting be improved?

McDonald's does not report on its impact, which makes it very hard to measure. Reporting could be vastly improved by doing a TruePrice or Future Fit analysis.

3.6. a. Thresholds: how does the company perform versus the planetary boundaries?

In other words: is the firm's sustainability performance good enough? It is hard to tell and the company does not indicate how big its contribution is versus how big it should be.

- On health, how many lives does the company touch and how much less health does it make those people on average?
- On the environmental side, what are the firm's carbon emissions and impact on biodiversity? How much can it do to reduce that?

In sum, the basic data are missing. The company could take inspiration from Novo Nordisk, which recently launched its Future Fit analysis.

MATERIAL ISSUES
Not all sustainability issues are equally important ('material') from an investment perspective. It is important to identify material sustainability issues, which may differ across companies and industries (Khan et al., 2016).

3.6. b. What are the most material ESG factors? I.e., what issues are most critical to the success of the company's business model?

The below matrix discusses for each of the most material ESG factors (1) how the company performs on it; (2) whether the company derives a competitive (dis)advantage from it; (3) how they might affect the value drivers.

TABLE 5: MOST MATERIAL ISSUES FOR MCDONALD'S & VALUE DRIVER IMPACT

Material issue	Performance	Competitive edge?	Impact on value drivers?
Product quality & customer health	See the externalities section. Strong in terms of reliability and safety as the company has a rigorous food control system. However, it is weak in terms of nutritional health. Did try to improve this but not welcomed by customers	They might have an edge versus peers when the industry is forced to change – i.e. suffer less	The health factor could be a very serious drag on sales and margins, and could potentially kill their business model
Human capital	Efficient and standardized personnel trainings; known for offering career opportunities to the young and inexperienced; praised on Glassdoor and Indeed. But, turnover is high and people make long hours. The company only recently stopped lobbying against a $15 minimum wage in the US.	Yes, they do seem to have an edge over peers	Higher margins
Environmental footprint	See the externalities section: hard to call	Hard to call	Higher cost of capital and potentially lower margins & lower growth
Brand management	Strong performance	Yes	Higher margins
Sustainable supply chain & waste from packaging	See the externalities section: hard to call	Hard to call	Higher cost of capital and potentially lower margins & lower growth

Source: authors' analysis

McDonald's did its most recent materiality analysis back in 2014. They don't provide a materiality matrix but do give their five priorities[17]:

- Climate action;
- Beef sustainability;
- Packaging and recycling;
- Commitment to families;
- Youth opportunity.

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[17] See: https://corporate.mcdonalds.com/corpmcd/scale-for-good/using-our-scale-for-good.html

Notably lacking among those priorities is the nutritional value of its products.

Integrated Reporting (<IR>) aims to improve financial reporting by giving a more complete picture of corporate performance, including non-financial or pre-financial performance.

3.7. How do you assess the company's non-financial reporting? And its approach to sustainability? How credible is it?

The company's sustainability reporting is limited. It published three supply-chain sustainability reports (coffee, beef, and packaging). However, the main focus of the reports is on providing anecdotal evidence on its best practices rather than disclosing the general sustainability performance and not-so-good practices. McDonald's does have sustainability goals, but there is little data and little information on the precise actions to achieve the goals.

In contrast, Philips's sustainability reporting is very advanced. The company has a long tradition in integrated reporting (since 2008) and sustainability reporting (since 1998). Notable features in its 2017 annual report include targets on circular economy sales, and the target of 3bn lives improved – making it one of the few companies that reports on impact. The report meets most of the seven guiding principles of an integrated report – except conciseness. It also has all the eight elements of an integrated report. Philips also has an environmental profit & loss (EP&L) statement.

3.8. Does the company (claim to) do Integrated Reporting (<IR>)?

No. This is unlike Philips, which has been doing <IR> since 2008.

3.9. To what extent do you see the seven principles of <IR> reflected in the company's reporting? Please fill out the following matrix (see also Table 6.3 in Chapter 6):

Unlike Philips, McDonald's does not score well on the principles of integrated reporting:

TABLE 7: *PRINCIPLES OF <IR> FOR MCDONALD'S AND PHILIPS*

Principle	Degree of application for McDonald's	Degree of application for Philips
Strategic focus & future orientation	~ reasonable	√ describe the path to value creation; 'roadmap to win'

Connectivity of information	~ some references given	√ there is quite a bit of cross-referencing
Stakeholder relationships	~ some stakeholder dialogues mentioned but no overview of stakeholder relations	√ Philips explicitly refers to its stakeholders and to its multi-stakeholder projects
Materiality	~ some priorities given, but not sufficiently. No materiality matrix	√ Philips reports a materiality matrix that rates quite a few E, S, and G issues on business impact versus importance to stakeholders
Conciseness	√ perhaps too concise	*X* report is still hundreds of pages long
Reliability and completeness	*X* too anecdotal, cannot get the big picture	~ Philips reports 'sustainability statements', which includes references to stakeholders; a materiality matrix, as well as data and targets on items such as lives improved, circular revenues, carbon footprint, waste recycling and supplier sustainability. However, it is not very clear how that affects financial results
Consistency and comparability	*X* no data	√ comparability of data versus other years is good, but comparability with other companies is limited

Source: authors' analysis

Unfortunately, McDonald's reporting level seems more typical of listed companies than that of Philips.

4. Strategy

Ideally, a company's strategy is aimed at long-term value creation (see Schoenmaker and Schramade, 2019, Chapter 5).

4.1. How would you describe the strategy of the company?

Unfortunately, the company does not explain its strategy in terms of the five elements of a strategy as defined by Hambrick & Fredrickson (2005): arenas, staging, vehicles, differentiators and economic logic. But the company does have

a clear growth strategy[18]. In this 'Velocity Growth Plan' it outlines how it aims to retain customers by extending the range of services; regain customers by providing better quality food and service; and convert occasional to committed customers. This is envisaged to be achieved through: healthier food, digitalization, and sustainability efforts. McDonald's shifts towards greater transparency and a more sustainable supply chain are encouraging. The 'Scale for Good' initiative includes sustainable supply chain, fiber packaging and recycling, healthier food for kids, and investments in people.

Leleux and Van der Kaaij (2018) describe how the arrival of new CEO Steve Easterbrook in March 2015 meant a landmark change for the company ('How McDonald's got its mojo back'). In the quest to improve brand relevance, the company's chief supply chain officer became responsible for sustainability. This shows that sustainability can play an important role in a company transformation – through its contribution to the relevance of the brand.

4.2. To what extent does that strategy take into account the company's most material ESG issues?

To a large extent it does. The above strategic choices suggest that McDonald's management understand their predicament very well, at least regarding the environmental side of their negative impact. Unfortunately, it is not yet visible in quantified targets and reporting.

4.3. Is the strategy consistent with the company's purpose? Please explain.

McDonald's aims to be its customers' favorite place and way to eat and drink (Mission statement 2013). The new strategy clearly relates to that (retaining & regaining customers). The link to sustainability is better captured by the company's intention to make people "feel good about visiting us", which includes the quality of food, customer experience, and even hints at its impact on the world. Indeed, McDonald's wants to attract customers by providing better food and services and building the image of a responsible company. However, it still looks like SDG washing. The big question is how thoroughly McDonald's will execute on this strategy, i.e. by setting and meeting measurable and ambitious targets, rather than just make some cosmetic changes.

4.4. What does long-term value creation look like? What are the best KPIs for it?

Long-term value creation for all stakeholders means decent returns on F, E and S:

- F: ROIC above the cost of capital

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[18] https://corporate.mcdonalds.com/corpmcd/about-us/our-growth-strategy.html

- E: avoid harm and ideally improve by providing solutions to others in reducing their harm. Possible KPIs include emissions; emissions reductions; % circular sales
- S: similar to E in terms of avoiding harm and providing solutions. KPIs: health effects; nutritional content of its food; sugar, salt and fat content; NPS; employee satisfaction.

In sum, there are not yet clear criteria for value creation in terms of E and S, but KPIs to proxy them do exist. Unfortunately, McDonald's does not disclose them.

4.5. What does management compensation look like? To what extent does management have long-term incentives? And are those incentives aligned with long-term value creation?

Management compensation seems based purely on stock and stock options. Claw-back provisions and non-financial metrics do not seem to be in place. Hence, long-term alignment seems limited.

4.6. How does the company communicate its long-term value creation with shareholders and stakeholders?

The company holds numerous stakeholder dialogues, but investor communications are more traditionally oriented on short-term profitability.

5. Value drivers – part 2

In Schramade (2016) it is described how analysts can make adjustments to their value driver assumptions based on how the company's most material ESG issues affect its competitive position.

5.1. Given all of the above questions & their answers, how do you rate the effect of material sustainability issues on the value drivers going forward? Per value driver, please indicate whether you see a positive, negative or neutral effect – and please explain why.

The value drivers are negatively affected by material ESG issues:

TABLE 7: VALUE DRIVER ASSESSMENT FOR MCDONALD'S

Value driver	Overall adjustment	Versus peers	Explanation
Sales growth	negative	positive	Healthier diets / taxes on unhealth food will probably hurt demand for fast food chains. However, McDonald's might enjoy an advantage versus direct peers.

Profitability	negative	positive	Adjustment to a healthier diet is hard to avoid and will likely result in higher costs, lower margins and negative scale effects.
Capital	negative	positive	Cost of capital will go up as sustainability risks begin to materialize in full force. Again, this will likely hurt peers even more.

Source: authors' analysis

These effects do not seem to be factored into current share prices.

5.2. How would this affect your valuation of the company?

As we put Table 7's assessment into numbers, we get the following results:

**TABLE 7: VALUE DRIVER ADJUSTMENTS FOR MCDONALD'S**

Value driver	McDonald's before ESG assessment	McDonald's after ESG assessment	Adjustment
Sales growth	3%	2%	-100bps
Margins	43%	40%	-300bps
Cost of capital	6.2%	7.0%	+80bps
DCF value	$184	$129	-$55 (-30%)

Source: authors' analysis

Admittedly, these are still point estimates, and one could better address the high levels of uncertainty with scenario analyses on the internalization of externalities, which could look like this:
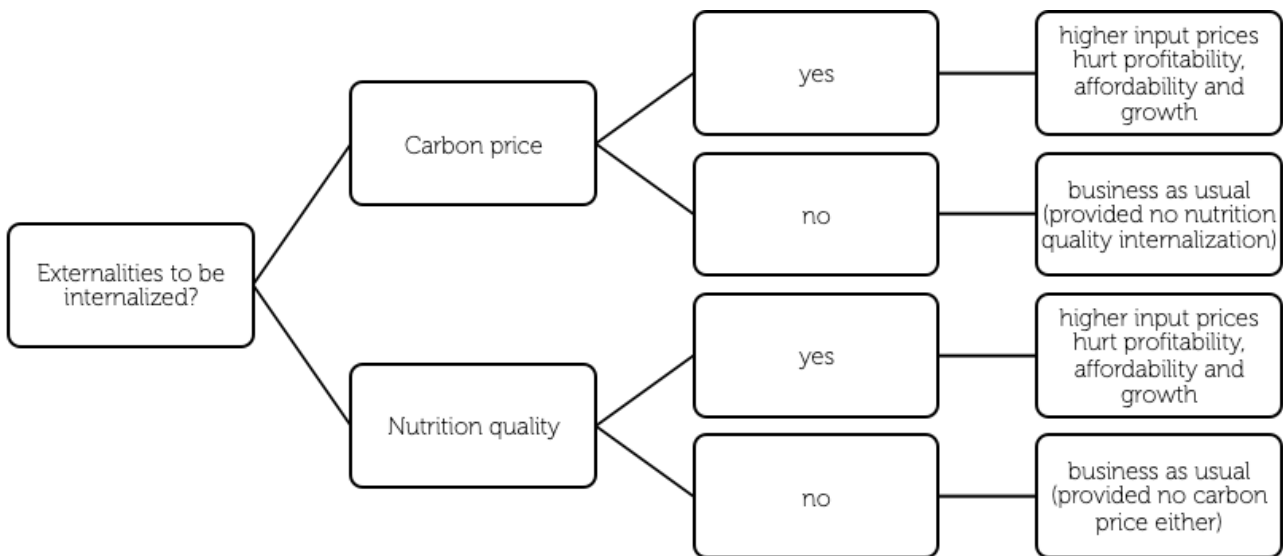
Source: authors' analysis

The next step would then be to add the following to each of these scenarios:

- An assessment of McDonald's ability to handle the resulting situations;
- value driver implications;
- probabilities (including joint probabilities!)

But it goes beyond the scope of this case study to conduct a full scenario analysis.

6.   Investment conclusions

6.1. How well prepared do you think McDonald's is for the transition to a more sustainable economic model?

It is hard to answer this question. On the one hand, McDonald's faces serious threats from its negative health and environmental externalities. And the company's reporting does not give sufficient information to quantify these threats, nor on the company's targets and incentives. On the other hand, the company does seem to have significant optionality in handling some of these issues – more than its peers or Air France-KLM for example.

6.2. How attractive do you find the company as an investment? Please explain and refer to your above answers.

McDonald's is widely viewed as an attractive investment case among financial analysts, who like the high margins of big brands in 'winner takes all' markets. The typical sell-side analyst report focuses on current issues like store modernization, and arrives at a target price by multiplying this year's expected earnings with a

multiple of say 25 because that happens to be the average historical trading multiple. However, a more long term oriented analysis like ours suggests that risks are much higher than typically anticipated.

6.3. What did you find most surprising when answering the above questions?

The student who analyzed McDonald's during the 2018 Sustainable Finance course in the RSM Master's program said the following:

"Although McDonald's is trying to become more sustainable, there is a contradiction between its strategy and the way the company is perceived (unhealthy, deep-fried, junk food). It is surprising that the company is trying to improve its image while at the same time stay true to its roots (burgers). The last attempt to make McDonald's healthier resulted in lower sales. I am curious to see how successful the new strategy will be."

6.4. If you were to engage with the firm, what topics would you address?

Key topics to address would be externalities and the improvement of reporting. On externalities, it would be good to understand their views on the likelihood and pace of externalization processes (views on consumer preferences; regulation; need for healthier food; carbon pricing etc.?) – and were they to dismiss those processes, that would be a serious red flag. On reporting, we'd welcome much more granularity on impact and the contributions to the SDGs: how big are those in both positive and negative terms? What is their view on sustainability thresholds? And could they please give historical data and quantitative targets on your most material issues?

And how accountable is top management given the lack of targets and data on key issues?

In addition, data on comparable firms would be most welcome, but ESG data providers or sell-side research would be the more logical source of such comparisons.

5 Conclusions and reflections

McDonald's is an interesting case because of the contrast between its strong financial performance (so far) and weak performance on externalities. Were those externalities to be internalized, McDonald's financial performance would likely suffer significantly. The long-term viability of its business model would also become questionable. Unfortunately, reporting is so limited that we lack the data to make a high conviction assessment of the company's transition preparedness. This is a serious disappointment, and represents a systematic shortcoming of corporate reporting practices.

On the website of the Erasmus Platform for Sustainable Value Creation (https://www.rsm.nl/erasmus-platform-for-sustainable-value-creation/home/) we publish similar cases for other companies. This allows for comparing McDonald's with companies in different predicaments. Like the other cases in this series, this one highlights the need for fundamental analysis (that is, going well beyond ESG ratings) to properly assess a company's transition preparedness, which we deem the essence of corporate sustainability.

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