

## McDonalds: Golden Arches indeed

*The McDonalds brand is acknowledged as one of the world's most recognizable and renowned brands. With a global footprint of close to 42,000 restaurants in 115 countries, the "Golden Arches" stands as the largest fast-food chain in the world. Famous for its fast-food sales, McDonalds generated revenue of \$25.5 billion in 2023 alone. However, contrary to what most would expect, the company's largest single source of revenue is not directly generated through its fast-food sales. This article explores the fascinating business model of the world's largest fast-food brand and explains how the company has established an inherent defensive quality that justifies it as a solid holding in share portfolios.*



**James  
Clarke**

Success as a fast-food business largely centers around producing scalable offerings. As a global restaurant chain with a presence in 115 different countries, McDonalds has achieved scale unlike any other single restaurant brand. This is evident to see even in the local midlands of KwaZulu-Natal, where recent developments of McDonalds stores in Hilton and Howick confirm the swift expansion of the

world's biggest restaurant brand. Since its establishment in 1940, McDonalds has built its global empire as one of the pioneers of fast-food franchising.

The company's franchise model has enabled McDonalds to accelerate store openings, drive profitability, and gain access to locally relevant expertise. Statistically, 95% of McDonald's stores are owned by franchisees, while the restaurant chain's remaining stores are company owned. The company receives revenue from its franchisee partners by charging them an initial franchise fee, increasing royalty payments as a percentage of sales, and selling them supplies at a marked-up price. On the other hand, the brand's company-owned stores generate revenue directly through restaurant sales. Surprisingly, however, the company's largest single source of revenue is not directly related to fast-food sales.

McDonald's business model was modified in the brand's early stages of development to add an additional source of revenue and a greater degree of control over franchisees. This involved the company becoming a landlord of its restaurant properties. As one of the world's fast-food trailblazers, McDonalds benefited from first mover

### SPEED READ

- With a global presence of close to 42,000 stores in 115 countries, McDonalds stands as the world's largest fast-food brand.
- Interestingly, McDonalds owns most of its restaurant properties, which have a total value of \$43.6 billion at cost. As a result, 39% of revenue is generated through rental income paid by franchisees. This rental income represents the company's single largest source of revenue.
- Predictable cash inflows from rental income have driven profitability and supported consistent dividend payments to shareholders over 47 consecutive years since the company's first dividend payment in 1976.
- While McDonalds is not immune to macroeconomic pressures and geopolitical risks that impact its sales, the company has built a defensive capability, which justifies it as a solid holding in investment portfolios.

advantage in many markets, helping secure a competitive advantage by owning some of the best sites. Today, McDonalds generally owns the land and buildings of its restaurants, which it then leases to franchisees. As evidenced by this arrangement, McDonald's isn't entirely a burger-flipping business. In fact, McDonald's former president once quoted: "We are not technically in the food business. We are in the real estate business. The only reason we sell fifteen-cent hamburgers is because they are the greatest producer of revenue, from which our tenants can pay us our rent."

## MCDONALD'S RESTAURANT



McDonalds isn't entirely a fast-food business. In fact, the company generally owns the land and buildings of its restaurants, which it then leases to franchisees, resulting in significant rental income.

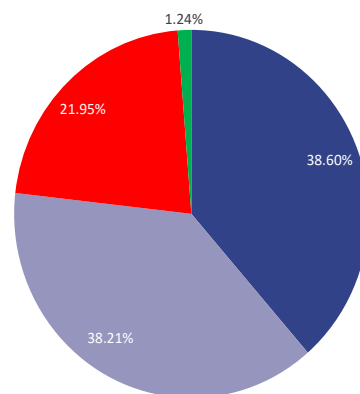
To present the significance of this real estate portfolio, McDonalds's real estate holding is worth \$43.6 billion at cost, equating to roughly 78% of the company's total assets. These real estate holdings operate similarly to residential apartments, which collect rent. However, franchisees are required to pay both a minimum rental payment at a fixed rate, as well as a variable rental payment, which is based on a percentage of sales. In 2023, McDonalds made total revenue of \$25.5 billion, of which rental income contributed \$9.48 billion. Therefore, McDonalds generated 39% of its revenue through rental payments from its franchisees, which stands as the company's largest single source of revenue.

The real estate business model of McDonalds stands out when compared to fast-food peer, Yum! Brands. Yum! Brands is the owner of western fast-food brands, KFC, Pizza Hut, and Taco Bell. Similar to McDonalds, Yum! Brands is predominantly operated by franchisees, as 98% of its stores are franchise operated. Across its brands, Yum! Brands has over 57,000 restaurants in more than 155 countries, which makes it a larger business than McDonalds. Interestingly, however, McDonalds generates 3.6 times more revenue. This is mainly a result of the comparatively large quantity of real estate that McDonalds owns.

While there are benefits to the asset-light model of Yum! Brands, the significant property holdings of McDonalds mean that the company receives more reliable cash inflows that can be increased by escalating rents over time. This rental income is an additional source of revenue for the brand that has little cost attached to it, resulting in increased profitability. Subsequently, McDonalds boasts industry-leading operating profit margins that currently stand at 45.7%.

Durable cash inflows from franchisee rent and royalty

## MCDONALD'S REVENUE BREAKDOWN



■ Rents ■ Company Operated ■ Royalties and Initial Fees ■ Other

McDonalds generates 39% of its revenue through rental payments from its franchisees, resulting in a steady stream of income.

payments have supported consistent dividend payments to McDonalds' shareholders over the past. The company has paid dividends for 47 consecutive years since its first dividend payment in 1976. These dividend payments have consistently increased at a strong rate and are well-covered by earnings.

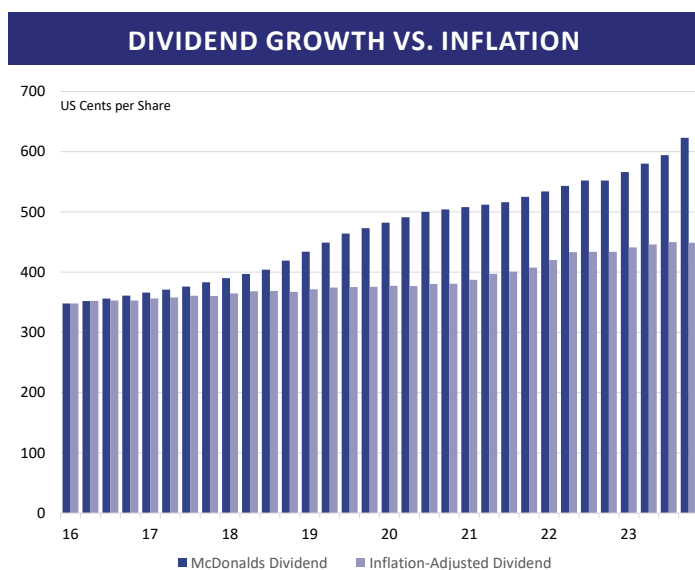
In addition to the company's lucrative real estate model, McDonalds has also developed defensiveness through its flexible menu offerings and pricing strategy. Importantly, the McDonalds brand identity does not associate itself with one specific product like competitor Burger King does, for example. This has been evident in the company's aggressive growth in the fried chicken market, while the company also contests in the coffee category with its McCafe offerings. Moreover, with the objective of being an affordability leader in the fast-food industry, McDonald's follows a pricing strategy that widens price points to

## MCDONALD'S VS. YUM! BRANDS: OPERATING MARGIN.



McDonald's real estate model generates greater profitability when compared to fast-food competitor, Yum Brands

broaden the addressable customer base, capturing sales from budget-conscious consumers while still providing for those who are willing to spend more.



*Stable cash flows have supported dividend payments to McDonald's shareholders, which have been paid consistently for 47 consecutive years since the first dividend in 1976.*

Evolving the brand's value-offerings to reach customers

has been a key focus for the company in the current operating environment as high interest rates affect consumer spending. McDonald's is experiencing moderating sales growth as consumers are being more discriminating on where they spend their money. Additionally, the company's sales have also been impacted by conflict in the Middle East as sales at those locations have been disrupted. Misconceptions about the brand's perceived support of Israel through social media has also weighed on sales figures. While expected to be transitory, the company does not portend any meaningful improvement in the same-store sales growth of its Middle Eastern markets until there is resolution to the conflict.

As illustrated, McDonalds is not immune to macroeconomic pressures and geopolitical risks that impact its sales. However, the company's business model creates a moat of stability and a competitive advantage over peers. Dependable cash inflows from rent and royalty income, which have little associated costs, have led to strong profitability and recurring dividend returns for shareholders. While strong performance over the past does not necessarily infer that the company will be a market-beating investment going forward, we believe that the company's fundamental defensive ability justifies it as a solid holding in portfolios.



*The golden arches are ubiquitous in the United States and Howick will soon have its own ones.*



By the time of our next Insight seminar, our election will be out of the way. We will take the opportunity to review market performance for the first five months of the year, and look ahead to what the second half might hold.

Please note that we will be hosting both a morning and evening presentation in Cape Town. The venues will be communicated once finalised.



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**Topic:** **Taking Stock: Mid Year Update**

### Natal Midlands

Date: 20 June, 2024

Venue: Oasis Conference Centre,  
72 Main Road, Howick

Morning Time: 10am for 10.30am

Evening Time: 5.30pm for 6pm

### Johannesburg

Date: 11 June, 2024

Venue: Rosebank Union Church, Cnr  
William Nichol and St Andrews  
Road, Hurlingham

Time: 7am for 7.30am

### Cape Town

Date: 13 June, 2024

Venue: To be confirmed

Time: 5.30pm for 6pm

### HARVARD HOUSE GROUP

 3 Harvard Street, Howick, 3290, South Africa

 P.O. Box 235, Howick, 3290, South Africa

 +27 (0) 33 330 2164

 +27 (0) 33 330 2617

 [admin@hhgroup.co.za](mailto:admin@hhgroup.co.za)

 [www.hhgroup.co.za](http://www.hhgroup.co.za)

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Performance figures quoted for the portfolio is from Morningstar, as at the date of this document for a lump sum investment, using NAV-NAV with income reinvested and do not take any upfront manager's charge into account. Income distributions are declared on the ex-dividend date. Actual investment performance will differ based on the initial fees charge applicable, the actual investment date, the date of reinvestment and dividend withholding tax. Performance fees do not apply to any funds managed by Harvard House. The manager does not provide any guarantee either with respect to the capital or return of the portfolio. A schedule of fees, charges, and maximum commissions are available on request from the manager.

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