Quarter Too Good to Ignore, Raising Our Estimated Fair Value of McDonald's

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Quarter too good to ignore...we're raising our fair value of McDonald's.

At Valuentum, we focus on the long-term intrinsic value of a company via a discounted cash-flow valuation process. That means building an extensive model for each company, and updating it when material events occur that may change our opinion. McDonald's second quarter results were very impressive, outpacing consensus as well as our estimates. As such, we have revisited our valuation and are raising our fair value estimate. We now forecast stronger top-line growth and better operating margins, the combination of which results in our current $87 per share fair value estimate.

Top-line and bottom-line surprised us.

We originally thought forecasting top-line growth in the double-digits might be a little bullish, given lackluster same-store-sales numbers earlier in the quarter. However, in its second quarter, McDonald's posted revenue growth of 16.1% and operating margins of 31.7%, which came in 120 basis points higher than our forecast. This culminated in diluted earnings per share of $1.35, beating our estimates by eight cents. We weren't expecting such large margin expansion (180 basis points over the previous quarter), given the input-cost headwinds that have impacted most companies. However, the advantage of being the largest restaurant-chain in the world allowed them to effectively squeeze suppliers and keep costs in check.

Several positives to take away.

We noted incredible sales in China (same store sales up a reported 14%) and continued excellence in supply-chain management as two of the biggest positives in the quarter. CFO Pete Bensen noted that most of the growth in China was driven by new customer traffic. This is meaningful, as getting people inside the store will not only drive new sources of revenue, but it will also build brand loyalty, while allowing customers to explore different and often higher margin options.

Additionally, growth in Europe was spectacular, considering the poor macro-economic situation and uncertainty in several core countries. Same store sales numbers were up 5.9%, and operating income was up 24% (though only 10% in constant currencies). Even Japan performed well, and only 17 stores remain closed due to the earthquake.

Even the US region did well, as same store sales increased to 4.5% in the second quarter, up from 2.9% in the first quarter. We think the company's focus on adding value to customers via inexpensive beverages and new product offerings are really resonating with customers. The reintroduction of the "Daily Double" value meal, priced below $4 in most regions, should be another factor in the firm's third quarter, and continued warm weather may keep driving traffic higher.

Shares continue to look fairly valued, but a pull-back could create an attractive entry point.

With shares surging to about $88, we think McDonald's still looks about fairly valued. However, we continue be fans of the company and have very little, if anything, to say negatively about its last quarter. Although McDonald's tends to be somewhat of a defensive name, we think a pull back could provide a nice entry point, with downside protection offered by its healthy dividend and share buyback program.