Takin' Care of Business

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McDonald's: Overvalued with storms brewing

Premium always comes at a price. Good investments are never easy to find, and selling a well-run company that has offered strong long-term returns is challenging to say to the least.

The S&P 500 (NYSEARCA:SPY) has been flat over the last six months, but McDonald's (NYSE:MCD) has rallied hard, up nearly 30% in the last year alone.

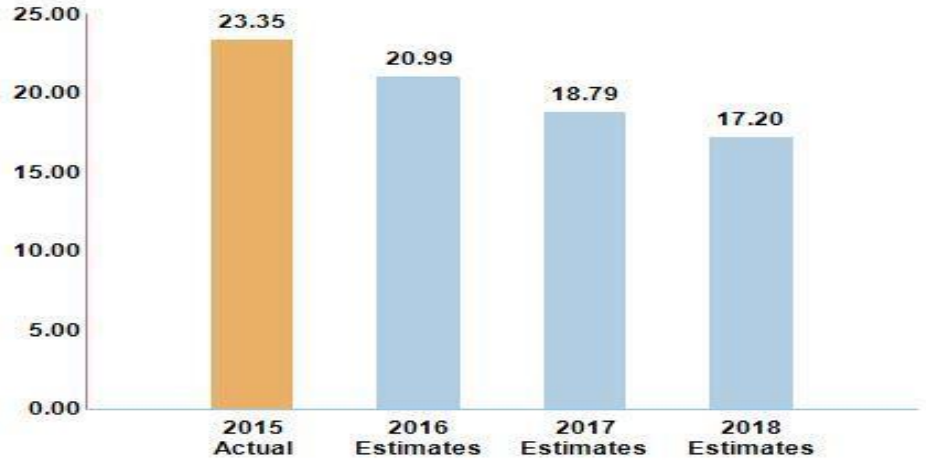
McDonald's is obviously a premium brand, but the stock trades at a significant premium even for this company.

McDonald's price to earnings ratio is at the higher end of the spectrum looking at the company's previous 20 years, and the stock trades at a premium to likely future earnings as well.

McDonald's currently trades at 22x 2016 earnings estimates and 19x 2017 earnings estimates. This is a heavy price to pay for a company that had 5% earnings growth and 7% net income growth in the past year. Analysts are also optimistically projecting earnings growth of 10% next year.

If McDonald's was able to consistently grown in the low double digits a 20x multiple would be justified, but the company will likely see growth slow in the next year for several main reasons.

First, McDonald's gets nearly 40% of revenues from Europe, with most revenue coming from the EU. Brexit is only one problem the company faces in the EU, with many European banks undercapitalized and the euro falling as well. A weak Europe and falling euro could hurt McDonald's earnings significantly in coming years. McDonald's sales at a higher price point in Europe, and the company's European operations are more susceptible to economic cycles.



Second, even a slight raise in the minimum wage could significantly impact McDonald's earnings. Hillary Clinton supported it during the Democratic primary, and if the federal minimum wage went to $15, McDonald's wage costs could grow from $8 billion to $20 billion.

Clinton only reluctantly endorsed a $15 dollar minimum wage under pressure from Sanders, and a raise to a $10 federal minimum wage with some states raising the minimum wage even more is probably the most likely scenario. Still, even a slight raise in the minimum wage would significantly impact McDonald's sizable labor costs.

Third, firms such as Nomura, who have been bullish on McDonald's for some, see domestic sales slowing in the second quarter. Nomura cited slowing burger sales in the second quarter as the primary reason the firm has turned negative on the stock that these individuals were bullish on for some time. McDonald's had recently boosted earnings in previous quarters with cost cutting and a changing franchise model, but the company will likely need to rely on increasing sales to boost earnings in the near-term.

McDonald's is one of the best run companies in the world, and the company deserves a premium valuation. Still, the company's recent earnings boost came from initiatives that are now in the past, and the world's largest burger chain faces several headwinds moving forward.

Even if Brexit does not significantly impact British and EU growth, a slowing EU could put pressure on McDonald's sales and create forex headwinds as well.

By Skeptical12 July 1, 2016
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