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McDonald's may yet regain its sizzle

The fast-food giant has faced adversity before – and always managed to emerge in a stronger position

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In the fast-food space, Tim Hortons and Burger King shareholders are having all the fun.

McDonald's investors, meanwhile, are like a kid who didn't get a toy with his Happy Meal.

As its competitors' shares soar on their $12.5-billion merger, McDonald's stock has done the opposite. Hit by a food safety scare in China, sluggish consumer spending and brutal competition, shares of the Golden Arches have skidded about 9 per cent over the past few months.

To be sure, McDonald's recent operating performance has been awful. After posting flat global same-store sales in the second quarter, sales at existing restaurants dropped 2.5 per cent in July. The APMEA (Asia-Pacific, Middle East and Africa) segment was especially weak, with same-store sales plunging 7.3 per cent after a Chinese supplier was accused of selling expired meat. The U.S. market was also a disappointment, as same-store sales fell 3.2 per cent.

So is it time to dump McDonald's? Nope. I'm sticking with the shares, which I own both personally and in my Strategy Lab model dividend portfolio (online at tgam.ca/DxlK). If anything, I might even add to my position if the price weakens further, because buying great companies when they're experiencing a temporary setback can be a profitable strategy.

As a dividend growth investor, I try to focus on the long run. Although McDonald's clearly has some challenges, the company has faced adversity before and, through menu innovations and operational improvements, always managed to emerge in a stronger position. I don't expect this time to be any different.

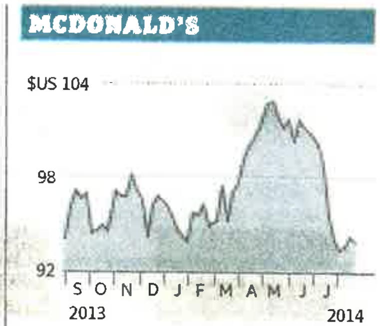
In the meantime, I'm getting paid a juicy yield of 3.4 per cent – and the dividend will soon increase again.

Since declaring its first dividend in 1976, the fast-food giant has raised its payment every year, through good times and bad. McDonald's typically announces dividend increases in September, and Bloomberg estimates that the next increase will be about 13 per cent. The actual increase may be more or less than that, but McDonald's has made it clear that sharing its massive cash flow with shareholders is one of its priorities.

Between 2014 and 2016, the company plans to return $18-billion to $20-billion (U.S.) to investors through a combination of dividends and share repurchases. This would represent an increase of 10 to 20 per cent compared with the previous three years, and it speaks to McDonald's commitment to rewarding investors. The funds will come from the company's free cash flow, debt financings and the franchising of existing corporate-owned restaurants.

No company can continue to boost its dividend in the absence of rising profits, of course, and although McDonald's earnings have hit a soft patch in the past couple of years, again it's worth looking at the long term.

For 2014, analysts expect McDonald's to earn about $5.57 a share. That's up only marginally from $5.55 in 2013 and $5.36 in 2012, but it's nearly double the $2.83 that McDonald's posted in 2006 and more than three times its earnings of $1.79 in 2004. So, clearly, McDonald's has not been standing still.



Close: $94.11 (U.S.), down 33¢

For 2016, analysts expect growth to pick up again, with earnings estimated at more than $6 a share. Indeed, although its domestic operations have stagnated, the company still sees plenty of growth ahead in emerging markets and is opening about 1,500 new stores a year worldwide. This represents growth of about 4 per cent on the more than 35,000 restaurants it now operates in 120 countries.

As for McDonald's struggling domestic operations, the company recently appointed a new president of its U.S. division. Mike Andres, who worked at McDonald's for 30 years before leaving for other roles, is rejoining the company and replacing Jeff Stratton, who is retiring after 41 years with the company.

Under Mr. Andres, McDonald's will try to reignite growth by rolling out new menu items, improving customer service and expanding sales of coffee and other high-margin beverages.

Although the past few years haven't been much fun for McDonald's shareholders, it would be foolish to count McDonald's out. With its global scale, strong brand name, formidable buying power and substantial free cash flow, the company will be rewarding dividend investors for many years to come.

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