MAGELLAN
EXPERTS IN GLOBAL INVESTING

Stock story: McDonald's

ESG risk management is on the menu.

McDonald's opened its first restaurant in 1948 and has since become one of the most recognisable brands in the world. The iconic golden arches were designed to draw attention to the company's pioneering 'Speedee Service System' that allowed McDonald's to serve its customers at speed, at lower cost and with consistent quality. It is this 'Quick Service Restaurant' design that enabled McDonald's to franchise. The company's reach has expanded to 39,000 restaurants in more than 100 countries that serve 65 million customers every day.

Given its size and industry positioning, McDonald's is exposed to numerous environmental, social and governance risks and opportunities, particularly in relation to the supply chain and labour management. It is important that these ESG risks are managed, to limit any threat to the company's cash flows and valuation. Communication of risks and how the company is mitigating them is crucial because transparency enables investors to better understand these risks. Magellan views that the key ESG risks and opportunities for McDonald's include:

- Labour. McDonald's is one of the largest employers in the US. Staff are vital as customer service is essential to operations. Consideration for diversity, equity and inclusion are important to culture, business continuity and brand.
- Health and wellness. McDonald's needs to ensure the items on its menu meet the changing demands of customers including their quest for healthy eating.
- Climate change. According to the UN Intergovernmental Panel on Climate Change, the global food system is responsible for 21% to 37% of global greenhouse gas emissions. Cattle are the largest contributors due to the methane they give off and land clearing for grazing. Investing in sustainable farming techniques is an important step to reducing emissions and lowering vulnerability to climate change for McDonald's.
- Raw material sourcing (including animal welfare). Improving the sustainability of sourcing reduces the environmental damage from operations. Importantly too is that this is the ethical path.
- The 'circular economy'. The term, which extends to natural resources, refers to the long-term sustainability of society, where there is less waste and more recycling of waste. Given the reliance of McDonald's on natural resources for packaging and food, it is important that management implement strategies to reduce waste and increase recyclability.
- Governance. It is important for all companies to operate ethically and in the best interests of shareholders.

As the world's largest restaurant chain, McDonald's attracts much attention from the media and investors. The McDonald's annual general meeting this year was no exception. Prominent activist investor Carl Icahn contested some of the proposals subject to shareholder voting at the meeting held in May. A contested ballot is uncommon. Less than 1% of Magellan's investments were subject to a contested ballot in fiscal 2022.[1]

At this year's annual meeting, Icahn called for McDonald's management to focus more on sustainability. In the context of the material ESG risks we monitor, Icahn's campaign was focused on a relatively narrow issue within McDonald's pork supply chain (sow gestation stalls – animal-rights activists say they are too small for pregnant pigs). To drive change, he submitted a shareholder proposal requesting a report from management on the issue and asked for two seats on the board to monitor compliance. Icahn had a tiny holding (just 200 shares) yet wanted director representation vastly greater than this ownership stake and out of proportion relative to McDonald's risks.

Contested ballots can be a distraction to management, but they can be a reminder that communication is critical to risk management. Ahead of the meeting, McDonald's management improved disclosure, providing much greater transparency relating to the activist investor's shareholder proposal on sow stalls. McDonald's outlined its collaboration with industry, its targets related to sow stalls, supply challenges due to covid 19 and progress to date. Although Icahn's proposal was voted down, it resulted in improved transparency, which is a good outcome for the industry.

The episode highlights that ESG risk management is important to asset owners. It is a reminder to asset owners that their vote matters and that asset owners can influence management. At Magellan, we value our right to vote. In this example, we reviewed the proposals, discussed the evidence, engaged with management and encouraged better communication. We concluded that McDonald's is managing the risk and as a result there would be limited impact on its valuation.[2]

Sources: Company filings

[1] A contested ballot or proxy contest is when a shareholder or group of shareholders attempt to drive change at a company. The activist investors typically seek a presence on the board with a view that the greatest change can be achieved from within.

[2] Magellan's ESG Philosophy is to consider all ESG risks with respect to materiality to cash flow and valuation.

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