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Deal focus: Trustar to stay invested in McDonald's China growth story

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The Carlyle Group is set to exit McDonald's China with a 6.7x return, but fellow investor Trustar Capital doesn't want to let go of a business that has doubled its store footprint since 2017 while maintaining robust same-store-sales growth.

Trustar Capital's plans for the asset are unchanged from three months ago: a portion of McDonald's China will be transferred into the private equity firm's latest fund, while the rest will go into some form of co-investment vehicle, according to four sources familiar with the situation.

Trustar declined to comment. McDonald's China didn't reply to requests seeking comment.

The size and structure of the deal have yet to be finalised, the sources added. Should it proceed as planned, Trustar would deliver a full exit for Fund III, which made the original investment in McDonald's China, and place a seed asset in the new fund, its fifth. Fund V is in the process of being raised.

An earlier attempt by Trustar and Carlyle to shift McDonald's China into a continuation fund, which didn't get past the soft marketing stage, valued their combined 80% stake at USD 4bn, as previously reported. Carlyle has agreed to sell its 28% interest for USD 1.8bn, two of the sources said, valuing the business at USD 6.4bn. One of the sources added that the price-to-EBITDA multiple was about 11x.

Carlyle's exit is to McDonald's Corp [NYSE:MCD], which will increase its holding in the China operation from 20% to 48% – six years after selling 80% to Carlyle, Trustar, and the Hong Kong-listed arm of CITIC Group for USD 2.1bn. The US-headquartered quick service restaurant (QSR) giant vetoed Carlyle's proposals to sell its stake to other unnamed investors, two sources said. Carlyle declined to comment.

Trustar started with 20% but now owns 42%, having acquired part of CITIC's stake in 2020. CITIC retains 10%. McDonald's is not expected to pursue part or all of the private equity firm's position. Joel Silverstein, president of East West Hospitality Group, which advises QSR brands on Asia market entry and private equity firms on QSR investments, noted that such action would be contrary to the company's broader strategy.

"I wouldn't be surprised if McDonald's sold shares down the line to an investor it feels comfortable with. McDonald's generally doesn't like to own equity in any business," he said. "Because of pressure from activist investors and other factors, they have been in a refranchising programme for years."

When McDonald's ceded control of the China business in 2017, there were approximately 2,500 outlets across the mainland, Hong Kong, and Macau. The plan was to add 1,500 more over five

years. This development target was comfortably exceeded – there are now over 5,500 outlets – and sales have grown more than 30% since September 2019, McDonald's said in a statement.

Silverstein added that same-store sales growth has also been strong, based on proprietary data he's seen. He is impressed by how the business has performed, noting that in numerous other instances in China's hospitality space, private equity investors have overpaid for, and struggled with, assets.

"From 2016 onwards, margins have eroded significantly. Rentals went up, labour costs went up, and there was food price inflation, but Chinese people were unwilling to pay much more for food," Silverstein said. "For Carlyle to get that kind of return is unheard of in China's restaurant industry."

Picking partners

QSR players like McDonald's and Yum Brands Yum! Brands [NYSE:YUM] tend to enter emerging markets as owner-operators of their stores due to a shortage of suitable partners for the traditional US franchisee model. According to Chris Tay, who operated QSR businesses in China before launching a consumer-focused private equity firm and a drink brand NOD, it is hard to find franchisees who follow the rules.

"They buy things from local supermarkets [instead of the brand owner] to get higher margins," he said. "McDonald's had a very strict approach to procedures and fees, which made it expensive to run a restaurant because high standards mean high costs."

In 2012, McDonald's adopted a US-inspired dual model, comprising small-scale franchises for existing stores at local level and provincial level development agreements with minimum store opening requirements. Five years on, about 600-700 of the 2,500 stores in mainland China were franchised out and the provincial businesses were underperforming.

This prompted the creation of a master franchise for the entire geography and the divestment of control to local partners. "From day one, the consensus view was that we would grow the business by ourselves instead of granting more franchises," Dejun Luo, then a managing director at CITIC Capital Partners, which later rebranded as Trustar, told sister publication AVCJ in 2019.

Approximately 90% of restaurants are still directly owned by McDonald's China. While a franchising programme is in place, partners are selected carefully. Silverstein compared the approach to that of Domino's in the US where it is difficult to become a franchisee without first serving as a store manager.

In 2022, McDonald's generated USD 23.2bn in revenue and USD 9.4bn in operating income. China is the company's second-largest market, contributing nearly 5% of system-wide sales and 3% of operating income. Most of the operating income was in the form of royalties, according to McDonald's. China revenue and EBITDA were USD 4.5bn and USD 410m in 2022, as previously reported.

Once under third-party control, McDonald's China pushed for greater localisation of the menu, which led to congee (Chinese porridge) becoming a key driver of the breakfast business. A WeChat mini-app was rolled out – forming the backbone of a loyalty programme that has gone from zero to 260m members – and delivery sales have seen compound annual growth of 33% over the past five years, according to one of the sources.

“While you might be doing the right thing as a brand, you might not be local enough to meet the modus operandi in China. Areas like site selection, supply chain, store management, and government relations are very important,” said Tay.

Size matters

Despite this progress, McDonald’s still trails Yum by some distance across most metrics. Yum has nearly doubled in size over the past six years with a store count that now exceeds 14,000, including 9.900 KFCs. The company ended 2022 with USD 9.6bn in revenue and 410m loyalty programme members. Nearly 90% of orders were transacted digitally and approximately 40% were for delivery.

In Silverstein’s view, the key differentiator for Yum is its comprehensive supply chain network, which has been assiduously built out over three decades. McDonald’s is not at the same level, but both companies have sufficient buying power to squeeze suppliers and minimise the margin contraction that is troubling many of their smaller peers, he explained.

And supply chain is increasingly the tool of choice when managing a fledgling franchisee network in China – to the point that bubble tea brands, for example, receive hardly any royalties and make most of their money from selling upstream essentials like ingredients to store operators.

“A brand owner or master franchisor has three kinds of leverage: real estate, where it holds the leases on properties and can throw out franchisees if they don’t pay; software, where it makes franchisees use its POS [point of sale] terminals and follow its rules; and supply chains,” Silverstein said.

“Overwhelmingly, supply chain is the main way to exercise control. Stores will be audited to make sure they don’t have weird ingredients in a back room.”