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McDonald's Corp. (MCD)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello, and welcome to McDonald's First Quarter 2020 Investor Conference Call. At the request of McDonald's Corporation, this conference is being recorded. Following today's presentation, there will be a question-and-answer session for investors. [Operator Instructions]

I would now like to turn the conference over to Mr. Mike Cieplak, Investor Relations Officer for McDonald's Corporation. Mr. Cieplak, you may begin.

Mike Cieplak

Corporate Vice President-Investor Relations Officer, McDonald's Corp.

Good morning, everyone, and thank you for joining us. With me on the call this morning are: President and Chief Executive Officer, Chris Kempczinski; and Chief Financial Officer, Kevin Ozan.

I want to remind everyone that the forward-looking statements in our earnings release and 8-K filing also apply to our comments on the call today. Both of those documents are available on our website, as are reconciliations of any non-GAAP financial measures mentioned on today's call with their corresponding GAAP measures.

Following prepared remarks this morning, we will open a queue for your questions. I ask that you please limit yourself to one question. And if you have more than one, please ask your most pressing first and then reenter the queue. Today's conference call is being webcast and is also being recorded for replay via our website.

And now, I'll turn it over to Chris.

Chris Kempczinski

President, Chief Executive Officer & Director, McDonald's Corp.

Thanks, Mike, and good morning. I would imagine we'll be spending a good portion of today's call discussing how COVID-19 has impacted our business, but I want to start by acknowledging the human toll of this pandemic. Let me express our deepest sympathies to those inside and outside of McDonald's who have been affected by this virus. In particular, I want to extend heartfelt thanks and gratitude to health care professionals, first responders and other essential workers around the world who have put their own lives at risk to help others.

The global crisis has impacted people in communities everywhere. In the face of such enormous challenges, I'm immensely proud of the entire McDonald's system and the tireless efforts of our franchisees, crew members, suppliers and company employees. Where we've been able to stay open safely and responsible, they've made it possible for McDonald's to continue offering great tasting, affordable and convenient food, amidst widespread change and disruption.

Turning now to our performance for the quarter, our Velocity Growth Plan drove strong results in 2019. That momentum carried into January and February. Since then, the outbreak of coronavirus around the world has created a major business disruption that adversely impacted our performance. Beginning in mid-March, we experienced a significant decline in our business due to the pandemic, dragging down our Q1 global comparable sales by 3.4%.

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We're now operating in a completely different world and we expect these changes to persist long after the crisis is over. In times like these, we take strength from the resilience and experiences we've developed over our 65-year history. While we're not immune to the immediate pressures threatening our global community, we came into the situation better positioned than most. And we believe that we will strengthen our competitive advantages following the crisis.

Entering the crisis, our system was in great shape. In addition to McDonald's strong balance sheet, franchisee cash flows in most of our major markets were at, or near, record highs in 2019. Our global restaurant estate had been largely modernized. And we've made significant investments to build new capabilities in delivery and digital that have proven to be critical to our business during the pandemic.

We now navigate through the crisis. McDonald's unmatched global footprint, scale and deep operational expertise are also proving to be significant strengths for us. Specifically, with a presence in over 100 markets, we've been able to develop insights and best practices as countries move through different phases of the outbreak.

In China, where the outbreak began, we quickly learned how to adjust our operations to enhance crew and customer safety. We developed new positioning guides and piloted contactless delivery. These solutions, along with many others, were then shared around the globe. As each country develops their own innovations, these are quickly shared by our Global Restaurant Solutions Group across all markets. Our systems' ability to quickly adapt operations across 40,000 restaurants has been incredible to see.

The size and scale of our supply chain has also proven to be a significant advantage during this crisis. To-date, despite the disruption to our business, we have had no break in supply for any food, packaging materials, toys, equipment, logistics or other solutions globally.

I want to give particular recognition to our supply chain team for sourcing vital PPE materials, such as masks. To give you just some sense of the scale with which we operate, our global supply chain team has sourced over 120 million masks to meet the needs of the McDonald's system.

And, of course, McDonald's strong drive-thru development has continued to allow us to safely serve millions of customers each day, while adhering to social distancing mandates or guidelines. In the US, nearly 95% of our locations have drive-thru and virtually all are open to serve health care professionals, first responders, other essential workers and customers looking for their McDonald's moment.

Similarly, Australia and Canada have been able to safely remain open. Finally, I should note that our global delivery sales are up significantly versus pre-COVID. Our restaurant footprint and customers' love for our brand make us an essential partner for any third-party operator.

Once we emerge from this crisis, our expectation is that McDonald's can further extend its leadership in every market where we operate. To do this, it's essential that our franchisees have the financial wherewithal to capitalize on the opportunities we think will be available to our system. For that reason, we've taken several steps to help our franchisees and Developmental Licensees maintain their liquidity and financial strength. While there will continue to be difficult decisions along the way, we are providing timely, targeted and temporary financial support, which Kevin will walk through in a few minutes.

From a customer perspective, we're encouraged by some of our early learnings that lead us to believe customers will be seeking known brands and familiar routines. We're also seeing a heightened focus on value and convenience. In China, this was reflected in the response to our recent Big Mac promotion. Showed that after a

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prolonged disruption of their daily lives, customers are craving comfort in our iconic core menu items. We've also seen this where we've been able to safely remain open in cities like Tokyo, Berlin and Chicago, and in Northern France, where we slowly began reopening restaurants last week.

As I mentioned earlier, our reopening efforts in our European markets will be phased and grounded in what's best for the safety of our customers and crew. Similar to what we did in US and Canada, we'll be serving a limited menu in many markets, focused primarily on our core items when we reopen in countries around the world. Through this, we will focus on what McDonald's has done so well for decades: serving great tasting food, fast.

This is a challenging and unpredictable time. Looking at comparable sales, we expect the second quarter as a whole to be significantly worse than what we experienced for the full month of March. Kevin will talk about what we've seen in the month of April.

As things stand, we believe we reached the trough in terms of number of restaurants closed in late March. We are planning for limited reopenings in markets in the near future. The exact trajectory of our recovery, however, is highly uncertain and dependent on many factors outside our control, such as: government mandates; the risk of a second wave of infections; the availability of testing; and the overall economic backdrop. We're developing contingency plans for a wide variety of scenarios.

From our experience in China, as well as from our experience closing and opening 10,000 restaurants as part of our EOTF remodel program in the US, we do know that customers will not immediately revert back to their pre-shutdown routines. For example, we know that breakfast will be the most challenged daypart. We know that a focus on core menu will be critical, due to both customer interest in familiar favorites and operational ease. We know that value will be a necessary element to reengage our customers. Each market is rebuilding their marketing calendar to reflect these learnings and many others, so we can reignite our business momentum.

But our first priority has been, and will continue to be, safeguarding the health and safety of our people and customers. The trust the McDonald's brand has developed over the last 65 years is our most precious asset. And we will never put that at risk. We remain closely aligned with the expert judgment of scientific and government leaders in our various markets. And we support the focus on widespread testing as a central element to broader recovery efforts.

Whatever the cadence of reopening markets, we know we can adapt. McDonald's is a remarkable system. And I'm confident that the strengths we've exhibited, both before and during the crisis, will be even more apparent as we emerge into a new post-coronavirus world.

I'll now turn it over to Kevin to talk about our first quarter results.

Kevin M. Ozan

Chief Financial Officer & Executive Vice President, McDonald's Corp.

Thanks, Chris. We began 2020 with strong top line momentum. Global comp sales were up 7.2% through February, reflecting strong performance in most countries around the world and the benefit of leap year. Beginning in mid-March, consumer traffic began to decline significantly, due to the impact of COVID-19, as we temporarily closed some restaurants and shifted to limited operations in others, when many parts of the world experienced government restrictions and shelter-in-place guidelines. As a result, global comp sales were down 22% in the month of March and down 3.4% in the first quarter.

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Today, I'll walk through March and April trends to provide perspective on how comp sales have progressed over the past few months. International Operated Markets comp sales were down 35% for the month of March. In the second half of March, comp sales were down roughly 70%, as several markets like France, Italy, Spain and the UK temporarily closed all restaurants. And other markets like Australia, Canada and Germany had drive-thru, delivery and take-away only for limited hours and menus. Comp sales have continued to be down about 70% through April in this segment, as many of the fully closed markets are now just beginning to reopen.

Turning to the US, comp sales were negative 13% for the month of March. Beginning in mid-March and continuing through mid-April, US comp sales were consistently down about 25%; however, we have begun to see some improvement in the last couple weeks. We expect April comp sales to be down about 20%.

Also, over the last several weeks, the US has experienced a significant increase in average check across all channels. This is due to an increase in party size as well as evolving consumer behavior, with daily routines interrupted and fewer transactions at the breakfast daypart.

Not surprisingly, the US has also seen sales impacted on weekends more than weekdays, as consumers leave their houses only when necessary. And we've seen a shift in sales mix by order channel, as nearly all restaurants are operating drive-thru, delivery and take-away only.

Prior to the impact of COVID-19, the drive-thru accounted for about two-thirds of all sales in the US. As consumers shifted from in-person ordering to drive-thru and delivery channels, drive-thru now accounts for nearly 90% of sales in the US. We're also seeing an uptick in delivery and digital transactions per restaurant. And all of these trends are similar to what we've seen in China and other markets.

Comp sales in the International Developmental Licensed segment were down 19% for the month of March. Similar to the other segments, in the second half of March, comp sales were down even more significantly, reflecting the impact of COVID-19 as it spread throughout the segment.

In China, approximately 25% of restaurants were closed in early February. By the end of March, substantially all restaurants had reopened; however, the market continues to experience a reduced level of demand as consumers have not fully returned to their pre-COVID routines, resulting in negative comp sales since the initial outbreak in late January.

Comp sales were down over 20% in the first quarter and trends have improved in April to negative mid-teens. In terms of new unit development, China opened over 100 restaurants in the quarter. We remain confident in new restaurant growth opportunities in China; however, we expect timelines to be delayed due to the crisis.

I want to transition to some areas that are most relevant to understanding the impact of COVID-19 on our results, including flow-through considerations on the P&L, corporate liquidity and franchisee financial health.

Starting with the P&L. As we've become a more heavily franchised business over the last several years, our operating model is designed to tap into the entrepreneurial spirit of our local business owners, and for efficient conversion of top line growth to the bottom line. In other words, as comp sales grow, the fixed nature of our franchise cost structure results in strong flow-through to the bottom line. Conversely, in the current environment of declining sales, we see less flow-through to franchise margin dollars.

Our Company-operated restaurant expenses are more variable in areas such as food and paper, and labor costs. So the flow-through to margin dollars is a bit better in our Company-operated restaurants in the current

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environment. For perspective, in March, with a comp sales of negative 22%, our total restaurant margin dollars declined $350 million, with about 75% of the decline driven by franchise margin dollars. Most of the decline was in the IOM segment, due to the significant number of temporary restaurant closures.

Turning to G&A, we saw an increase of about $95 million in constant currencies, or 19% versus first quarter last year. About two-thirds of the increase relates to nonrecurring costs, including: $40 million for the cancelation of our biennial worldwide convention; and roughly $20 million related to payments of contractual obligations as we reduced the scope and ongoing spend in R&D work of certain restaurant technology. The remaining increase relates to the run costs associated with our acquisitions of Dynamic Yield and Apprente, as well as continued depreciation and amortization costs related to technology. As a reminder, both of these acquisitions occurred subsequent to first quarter 2019, so we're not lapping those acquisitions yet.

Our investment in digital customer engagement remains a priority for our business. And, as I'd mentioned before, we've already seen the benefits of Dynamic Yield in our operating results. These digital investments enable us to give customers more choice and flexibility in how they order, pay and receive their food during this unprecedented time, and will remain important in serving customers as we think about our business beyond this crisis.

As we navigate through uncharted waters, we're taking a disciplined approach to decision-making. This includes reviewing all investments and reducing or delaying spending as we rescope priorities in some areas and redirect dollars to other priorities. We're focusing resources on projects and initiatives that can reasonably be implemented and executed in the near term, both in terms of cost and time, and will also benefit the system for the long term. As we make these assessments, we'll also prioritize our resources against the most critical needs of the businesses.

Due to COVID-19, we expect a few lines of the other operating section of the P&L to be impacted in 2020 as well. Gains on restaurant sales are expected to be down about $100 million, as a result of minimal restaurant sale activity for the rest of the year. Our equity and earnings of affiliates is expected to be down substantially. And we expect to have some additional reserves for bad debts related to rent and royalty deferrals subsequent to March.

The result of all of this is that we expect our operating cash flow to be down significantly this year. We entered the crisis with a strong balance sheet. And we've taken a number of actions to preserve financial flexibility. In addition to currently reviewing our G&A costs, we suspended our share repurchase program in early March. We secured $6.5 billion of new financing in March, including $5.5 billion of debt issuances at various maturities and a new $1 billion line of credit that we drew upon immediately.

In terms of capital expenditures, we've taken a very practical approach to development activity. We suspended Experience of the Future ground breaks in the US and new restaurant openings around the world, as COVID-19 began to spread. Given that our first quarter CapEx is typically about 20% of the full year and many projects are delayed or on hold, we now have some flexibility with decisions for the majority of our planned capital spend for the year. As a result, we're reducing our 2020 spending by about $1 billion from our initial expectation of $2.4 billion.

I also want to acknowledge our dividend. We paid our first quarter dividend at the beginning of March, prior to the widespread impact of COVID. McDonald's remains financially strong. And our capital allocation priorities remain investing in the business for growth and prioritizing dividend to our shareholders. We will continue to manage and utilize our funds in a judicious manner that focuses on ensuring the company is able to grow the business and our franchisees remain financially strong.

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As I mentioned earlier, we've taken a number of actions to ensure that the company is in a sound financial position and to put our franchisees and Developmental Licensee partners around the world in a position to be successful in running their businesses. As COVID spread quickly around the world, our first step was determining operating procedures, resulting in temporary closures of all restaurants in some countries and limited operations in others, as I've mentioned.

That was quickly followed by providing broad-based financial liquidity assistance in the form of rent and royalty deferrals that were generally applicable to all franchisees within various markets, because we needed to make quick decisions to alleviate franchisee concerns and put them in the best position to maintain their businesses.

Generally, we've deferred the collection of rent and royalties earned in March and April in most markets around the world. Cash is collected on a one month lag, so the cash impact of these deferrals occurs in April and May. This deferral amounts to roughly $1 billion of liquidity assistance that we committed to our franchisees and Developmental Licensee partners across the system.

We also worked closely with lenders, suppliers and distributors to extend payment terms to franchisees, where necessary. Now, we're assessing the financial health and liquidity of specific at-risk franchisee and Developmental Licensee organizations. This assessment includes various sales projection scenarios and takes into account the impact of liquidity assistance measures provided by the company, suppliers, lenders and governments.

We've developed an objective framework for making decisions regarding which specific franchisee and DL organizations may need further liquidity assistance and how we may support them. This will help ensure a consistent and equitable approach to decision-making across all of our markets. As Chris mentioned, our general philosophy is for any assistance to be timely, targeted and temporary. The financial health and strength of our franchisees has been a competitive advantage for McDonald's for years, and we expect that to continue post COVID-19.

Now, I'll turn it back to Chris.

Chris Kempczinski

President, Chief Executive Officer & Director, McDonald's Corp.

Thanks, Kevin. While there's much we don't know about the future course of this pandemic, we are taking the necessary actions to ensure we emerge from this crisis in a position of strength. Looking ahead, we know these unprecedented times will bring about some fundamental changes to the way businesses, including ours, operate. What will remain constant is our commitment to maintaining the strong level of trust our customers have in the business.

We're also beginning to think about our strategy in the aftermath of COVID-19. While elements of the Velocity Growth Plan will continue to be important, we're making adjustments in real time and there will likely need to be further changes. We'll look to provide updates on our overall progress later in the year.

In these challenging times, I'm immensely proud of the way our system has banded together to stay true to our purpose to feed and foster community. The countless inspiring examples of this around the world showcase the real impact McDonald's has in the communities in which we operate.

I'm proud to share a handful of these stories. In the US, our restaurants are offering our appreciation with free Thank You meal boxes to first responders and health care workers to thank them for their tireless efforts to

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protect us all. These include favorite breakfast and lunch menu items packaged in Happy Meal boxes with a thank you note in place of a toy. We're in the middle of this two-week show of appreciation and we've already provided nearly 4 million Thank You meals.

Across Europe, many markets are providing free drinks, coffee and meals to first responders and health care workers on the front lines. In Madrid, a restaurant just reopened solely to serve frontline workers at the nearby hospital.

In Australia, we've added staples of milk, eggs and bread to our menus, enabling customers to use McDonald's contactless drive-thru and take-away to shop for basics, providing a safe and easy way for customers to shop.

And in many of the communities around the world that we call home, extra food within the supply chain is being redistributed through nonprofit organizations and local food banks to feed communities in need. We've also donated nearly 1.5 million masks to COVID relief efforts.

As I said earlier, we entered this crisis with a solid foundation. While we face significant disruptions and challenges, we remain confident in our ability to adapt, as we've done throughout our 65 years, to secure our long-term success.

And now, we'll begin Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions]

Mike Cieplak
Corporate Vice President-Investor Relations Officer, McDonald's Corp.

A

Good morning. Our first question is from David Palmer with Evercore.

David Palmer
Analyst, Evercore ISI

Q

Thanks, and good morning. So far in April, it sounds like the US has seriously diverged from your trends in other international markets. So just focusing on those international markets and obviously a lot of that weakness has been closed stores, but I would also imagine that those would be more vulnerable to COVID-type formats, like higher walk-in mix and there might be other economic and structural factors that might linger. So can you give us a sense about how things look in those markets as you get back to reopening? And do you see the snapback as strong as it's been in the US? And then, perhaps you can dig into that comment about the support you're offering to franchisees, especially in those hardest-hit markets. Thanks.

Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Morning, David. Thank you for the question. And you're right. In the international, particularly in our IOM markets in Europe, we have a number of countries that are completely closed, based on government mandates. We are just beginning the process of reopening on a limited basis in a number of those markets. And so, it's probably a little premature for us to give you any indication of what the overall trajectory is going to be. But I would say we've been really encouraged, when we do start to open limited restaurants, by the demand.

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You may have seen in the last week as we've opened up in a few of these markets, we had a three-hour wait at one of our restaurants in France for people to get through the drive-thru. In Austria, we had a 2-mile line of people looking to get into the drive-thru. And I think our overall view is as markets start to open up, this desire to really return to familiar favorites, to brands that are known, is very, very powerful. And I think the fact that we also have a strong orientation toward convenience and value that I think are also two key elements.

We are optimistic. We certainly are expecting that we're going to be able to take share in those markets. And so, I think we, like everybody else, are closely watching what the overall level of customer demand is going to be. We do feel like we're well-positioned on that, but probably too soon to say.

In terms of financial support that we're providing to franchisees, let me pass it over to Kevin to address.

Kevin M. Ozan

Chief Financial Officer & Executive Vice President, McDonald's Corp.

A

Yeah, hey, David. Related to the franchisee assistance, I'd say it's similar to what we've done in the US. As I talked about in my remarks, at the beginning, what we really did was kind of this broad-based assistance that was deferring a couple months of rent and royalties, generally for most franchisees around the world. The other thing that's happened is essentially we've converted our rent to variable rent based on sales. So the restaurants that have been closed effectively aren't paying rent because they don't have sales.

The only other thing I would point out is there's various different forms of government assistance in each country. So certain countries provide more assistance related to kind of workers who aren't working temporarily. Which means that in some of the markets, they've been able to effectively help the franchisees in terms of being able to keep their workers, but not if the – that payment doesn't come out of the franchisees' pockets while the restaurants are closed.

And then, in several markets, we've actually been working with other companies to actually even find places where our employees have been able to work. So in a couple of them, we've partnered up with companies like ALDI and others to provide temporary employment for our workers while our restaurants are closed. So I wouldn't say that our assistance is substantially different on the international side. Again, we started at the broad based and now we're looking at individual organizations to see where we may need to step in, both internationally and in the US.

Mike Cieplak

Corporate Vice President-Investor Relations Officer, McDonald's Corp.

A

Our next question is from Andrew Charles with Cowen.

Andrew Charles

Analyst, Cowen and Company

Q

Great. Thank you. And I hope you all are staying safe and sheltered. Now that we're a month and a half into the crisis domestically, I wanted to learn more about the best practices you are implementing into the US that have been proven in international markets amid COVID-19. It seems like the sales improved from down 25% to down 15% from the first half of April to the back half of the month. What would you attribute to that improvement? Has there been part of the strategy that you lean more into around digital, value or resumed advertising? Or would you call it that maybe the improvement that you're seeing thus far is a result of stimulus checks and consumers growing more comfortable venturing outside the home as a contributor? Thanks.

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Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Yeah, hey, Andrew. So maybe let me take it in two different pieces there. I think in terms of the best practices, we have learned a lot around how we adjust operations to really make sure that we're providing a safe environment for our crew and for our customers. In almost every market where we operate, the US included, there are dedicated teams that are meeting daily and reviewing procedures and connected to our Global Restaurant Solutions Group to understand these best practices.

In the case of the US, they've made 50 different changes to operating procedures as we've learned more. And it's everything from: positioning guides; to protective barriers; to other things like masks; how often, how frequently we are sanitizing surfaces. Just a variety of different things. So that has been really helpful for us in terms of just making sure that our restaurants continue to be a safe environment for both customers as well as for our crew.

I think that certainly does help with the demand that we're seeing. I think as people get confident about our ability to continue to offer food in a safe way, that certainly helps. But there is a benefit that I think you could attribute to the stimulus checks. I think there's probably also, as customers are starting to venture out a little bit more, this desire to really go to familiar brands. You know, you saw it in the at-home occasion, center-of-the-store, familiar brands in grocery really benefited as people were staying home. I think that same dynamic is going to be at play as people start to come out looking for familiar brands. So I think there's a variety of different things at play there in the US, but certainly we've been more encouraged by what we've seen the last couple weeks in the US.

Mike Cieplak
Corporate Vice President-Investor Relations Officer, McDonald's Corp.

A

Our next question is from Eric Gonzalez with KeyBanc.

Eric Gonzalez
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey. Thanks. And hope everyone's doing well. So in the current environment, franchisee health is a big topic. And I understand the need to limit what you tell the public. But in the past, you've given some detail on what's happened to franchisee cash flow. And it also seems like a lot of operators have increased debt loads quite significantly to cover the remodels and tech upgrades. So the question is: are rent and royalty deferrals enough to prevent some of your bottom-quartile franchisees from failing? And I think you alluded to this in the prepared remarks, but there may be some other options on the table. So if you could talk about what those might be for those troubled franchisees. And then secondarily, regarding the CARES Act and the PPP relief, would you be able to say what proportion of your stores actually qualify for some government assistance there? Thanks.

Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Yes. So I think what Kevin talked about, I'll talk just sort of philosophy and then give Kevin the handoff in terms of any more details. But the first phase of this crisis, essentially we wanted to move with speed. And so, that was why we just pushed a lot of liquidity out into the system, both from what we did as well as what our suppliers did, to just, in that initial phase, make sure our system had the sufficient liquidity. And that was the broad-based deferrals that Kevin referenced. Now, as we've had more time, we've essentially been able to go through and do stress tests, if you will, for every single franchisee organization and have developed a sense of what we think their liquidity needs are under a variety of different scenarios in terms of how this business recovers.

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I think the important point that Kevin talked about in terms of the principles of timely, targeted and temporary, is we will provide the support when it's apparent that what the scenario is that we're dealing with. So that's the timely element, which is, who knows how any of this progresses. But we certainly have a sense of, depending on which trajectory we go, who's going to be at risk. And then, I would say we have a full suite of tools at our disposal to address those situations. But, Kevin, if you want to add anything to that.

Kevin M. Ozan
Chief Financial Officer & Executive Vice President, McDonald's Corp.
A

Yeah, I'll just add a little bit. I guess, one, I would just remind everyone that we did come into 2020 with most of our franchisees, in most of our major markets, either at or near all-time high cash flows. So most came into the year in pretty good strong position.

To your point, there are some franchisees, in some markets, that are more highly leveraged, I'll say, than others. So we are cognizant of that and certainly are having the appropriate discussions with those franchisees. And to Chris's point, I think now we're at the point where we are looking at organization-by-organization and seeing where we may need to step in and provide further assistance, or make sure that they're getting all the assistance they need from lenders, suppliers, et cetera.

Related to kind of the loans, I guess I would just remind everyone, our operators are small independent business owners who are eligible for the loans. They're working with their advisors to determine kind of the needs for their business. Our understanding is that most have been able to get approved, which would enable them to keep paying their crew and continue running their businesses. And then, we're certainly continuing to work with them to make sure that they've got the liquidity to keep running their businesses. So I think we feel pretty comfortable in general about franchisees, but there certainly will be a few that we need to just think about how they get further assistance if they need.

Mike Cieplak
Corporate Vice President-Investor Relations Officer, McDonald's Corp.
A

Next question is from David Tarantino with Baird.

David E. Tarantino
Analyst, Robert W. Baird & Co., Inc.
Q

Hi. Good morning. Hope everyone is doing well. Kevin, I just wanted to ask a quick follow-up to that last comment. Is there any way to maybe bucket how many of those franchisees or what percentage of the system would fall into the category of you might need to offer additional assistance? And then, my second part of the question is really related to how you think the cash flows will shape up in the short run, if there's any metrics you can share in terms of cash burn rate for the second quarter, for example, that would be helpful. Thanks.

Kevin M. Ozan
Chief Financial Officer & Executive Vice President, McDonald's Corp.
A

Sure. Thanks, David. It's a small percentage. I'll leave it at that. But it's a pretty small percentage. This is not a large majority of operators or a large piece of the operators. It's generally maybe a few operators in each market that we're working with. So it isn't a widespread issue that we're dealing with.

Related to cash flow and let me try and put that in some context. And I'll go back and just – I may repeat some of the things I mentioned in my remarks, but remember, we entered the crisis certainly from a position of financial strength. From a corporate standpoint, we have a strong investment grade credit rating. That's always been

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important to us, so we're been maintaining that. And I talked about our franchisees also entered into the year pretty strong financially.

As we got into this year and the impact of COVID was growing, you would've seen that we acted pretty quickly to bolster our cash position, certainly in anticipation of the changing macroeconomic and business conditions around the world.

We secured $6.5 billion of new financing in March, which was $5.5 billion of bonds and $1 billion of line of credit. And then, we also still have full access to a committed line of credit of $3.5 billion.

So I know cash burn is a frequent topic of discussion lately. We certainly keep our eye on that, but we do have confidence in our liquidity position, based on our current cash balance and our ability to get further access, if we needed it, in the markets.

We ended the first quarter a little over $5 billion of cash on our balance sheet. And, again, remember we still have that $3.5 billion line of credit that's untapped, if we ever should need it.

I'd say our cash outflows right now are fairly consistent month-to-month for things like G&A and capital and lease expense costs. In this environment, the big variable is the cash inflows, because, as you know, we operate in over 100 countries. We've given some of those rent and royalty deferrals, of over $1 billion. And now, we're looking at those individual operator organizations that may need something further.

Having said all that, between the temporary restaurant closures and the deferrals, our cash inflows certainly will be significantly less in the second quarter than normal, so we're likely to have negative free cash flow in the second quarter. But assuming that the countries continue to reopen on the schedules that we're seeing right now – and, again, most of those are in the European markets, and assuming franchisees then can have the ability to pay their rents and royalties, we would expect that the free cash flow would turn back to positive in the third quarter. So we do think second quarter will be a rougher quarter in terms of cash flow, but right now, based on current plans, we would expect that to turn around back to positive in the third quarter.

Mike Cieplak
Corporate Vice President-Investor Relations Officer, McDonald's Corp.

A

Our next question is from Sara Senatore with Bernstein.

Sara Harkavy Senatore
Analyst, Sanford C Bernstein & Co., LLC

Q

Oh, thank you. I wanted to ask a bit more about sales trends, both before and after the emergence of COVID-19. So before January and February, you noted that comp was balanced between traffic and ticket in the US. I guess if you could just talk a little bit about does that account for leap year? And effectively you haven't had positive traffic in the US in a while. I'm trying to understand what the drivers might have been.

And then, after the emergence of the pandemic, you've talked about global delivery sales being up significant. Could you just quantify share of sales or year-over-year growth in delivery and maybe give some color on digital ordering as well, since presumably even some of the drive-thru orders or carryout would have been digital? So just a little bit more context before and after.

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Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Sure. So on your first part of the question with the US, we did get off to a really strong start. The team was very excited about the US results through February. As you know, we were up over 8% for the first two months of the year. And a good amount of that was due to traffic. We were really encouraged by the traffic trends that we were seeing entering into the new year, and that excludes the extra benefit that we then got through leap year. So we were in a good traffic position through the first couple of months in the US. Leap year further helped that. And then, we had COVID and you know kind of the rest from there in terms of what we've been working through.

I think from a delivery standpoint, the important thing is the vast majority of our business is still drive-thru-driven in the US. And so, while delivery is up significantly, it's not the predominant thing that is driving our business. The predominant channel is really through the drive-thru.

Kevin, I don't know if you have anything else you want to add.

Kevin M. Ozan
Chief Financial Officer & Executive Vice President, McDonald's Corp.

A

No. But we certainly have seen some markets around the world, like Canada, for example, delivery sales are up 40% since. So part of it's dependent on the market and the – I'll say the penetration of drive-thru, as Chris mentioned. Certainly, drive-thru in the US has gone from two-thirds of our business to about 90% of our sales right now. But we certainly are seeing both delivery and digital sales up in the US and in some markets seeing it up more than the US, even, from pre-COVID times.

Mike Cieplak
Corporate Vice President-Investor Relations Officer, McDonald's Corp.

A

Our next question's from Jeff Bernstein with Barclays.

Jeffrey A. Bernstein
Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much. Just trying to get some historical context, for whatever historical means, in terms of COVID. But China seems like some good intelligence. I'm just trying to assess the pace of recoveries through the crisis. It seems like you mentioned it was down more than 20% from a comp perspective in the January/February timeframe. Wondering if maybe you can give some sort of a monthly trend, as that market, I think you said, is now down mid-teens. So it would seem like a five-point-plus improvement but over multiple months. So it seems like maybe it's slower than some had hoped. I'm just wondering maybe if you can...

Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Yes.

Jeffrey A. Bernstein
Analyst, Barclays Capital, Inc.

Q

...list out the primary factors. [ph] Looks like you said the (44:40) US is much more quickly improving. I think you said it started April down 25%. And just within the month, it's now only down 15%. So anything you can compare and contrast between China and the US in terms of how we think about the recoveries around the world would be great. Thank you.

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Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Sure. So I think there's – as you mentioned, there's a number of things that we're learning from China. A lot of it was around operational elements that I described earlier in the call. We've certainly also been watching and learning as China's been able to approach the digital side of the business, I think they are further ahead than most of our markets in terms of how they use digital. So a lot of good [ph] learnings there, (45:23) but, as you mention, as we've referenced as well, the pace of recovery in China has been slow. We're not seeing a V-shaped recovery in China. The business trends are improving, but they're still running negative to where we were a year ago.

I think there is a couple things that are worth just noting as to reasons for that. The first is we had substantially more restaurants in China that were fully closed and then have to reopen. So that's a larger disruption than if you're able to kind of continue to be open and then just moderating your channels. So that was one issue.

The second is just a reminder, in China, only 15% of the restaurants have drive-thru. And I would say one of the things that we have seen as a real strength of our business is drive-thru penetration. And so, when you have a strong drive-thru penetration, I think your ability for that business, that market, to bounce back, that's certainly an added benefit. Kevin, I don't know if – anything else you want to add.

Kevin M. Ozan
Chief Financial Officer & Executive Vice President, McDonald's Corp.

A

No. I think those are the biggest things. There are some consumer trends, I'd say, that we're seeing similarly, which are weekdays recover quicker than weekends as people start to go out again. Breakfast is a little slower to recover than other dayparts. And then, obviously, as we get into summer, that could still be impacted by things like reduced vacation, holiday travel, et cetera. So some of the consumer trends are similar, but, to Chris's point, the big difference to me is that we've got much more drive-thru, certainly in the US and those restaurants remained opened. Whereas in China, the restaurants [ph] were (47:18) fully closed for a while.

Mike Cieplak
Corporate Vice President-Investor Relations Officer, McDonald's Corp.

A

Our next question is from John Glass with Morgan Stanley.

John Glass
Analyst, Morgan Stanley & Co. LLC

Q

Thanks, and good morning. On the IOM comp trends, a couple of questions. One is, I know we can do the math, but just to be clear, of the stores that are not closed, what are the comp trends in those markets? And you were just talking about China and drive-thru and that's a critical differentiator in the US, for example. What percentage of the IOM markets have drive-thrus? What percentage offer breakfast? I know it varies, but if there's an average or some anecdotes there. And then, Kevin, I just want to make sure I clarify your dividend comment. You said you're acknowledging the dividend. Does that mean that it's under review or it's not under review? Just making clear what you said about the dividend and your decisions around that. Thanks.

Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Yeah, so I'll start with just an overall comment about IOM and the European markets. It is tough to generalize. I mean, I've got to say that every market is in a different situation based on what's happened from government mandates, just the overall orientation of that market, so difficult to generalize. Certainly, I think you can conclude that in restaurants that are open, comp is still down. Comp is down, reflecting just a lower level of economic

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activity. People are still largely staying at home, even in markets that are able to remain open. So that is adversely affecting, even in restaurants that are open, comp trends. But, again, it varies really market-by-market.

I think if you then go to your second question, which is about percent of restaurants, primarily in Europe, again, I'll focus there, that have drive-thru, the majority of our restaurants have drive-thru in Europe. It does vary market-by-market, but the majority of our restaurants do have drive-thru. So that certainly is something that we expect to be helpful to us as we emerge out of this.

And then, Kevin, I'll flip the other questions over to you.

Kevin M. Ozan A
Chief Financial Officer & Executive Vice President, McDonald's Corp.

Yeah, related to the dividend, John, yeah, what I'm saying is I'm reiterating our capital allocation priorities, which is investing in the business for growth, which includes supporting franchisees where necessary, and prioritizing the dividend because we know that's important to our shareholders. Our normal quarterly process, just because of timing, is that we'll provide a recommendation to the board later in the quarter for the second quarter dividend. So we haven't changed our normal process, at this point. It's our ongoing process that we would go to the board in the next month or so with our recommendation for the dividend. So that's still intact, that process.

Mike Cieplak A
Corporate Vice President-Investor Relations Officer, McDonald's Corp.

Our next question is from Chris Carril with RBC.

Christopher Carril Q
Analyst, RBC Capital Markets LLC

Hi. Good morning and thanks for taking the question. So can you please provide some more detail on the flexibility you have with CapEx and any additional detail on what makes up the $1 billion reduction this year? And on the remaining domestic EOTF remodels that were in the pipeline for this year, can you talk a bit about how franchisees are thinking about the timing of those remodels? Is the thought process to complete them as soon as feasible or are franchisees seeking to largely just delay beyond this year? Thanks.

Kevin M. Ozan A
Chief Financial Officer & Executive Vice President, McDonald's Corp.

Yeah, thanks for the question. So we've said we're going to reduce CapEx by roughly $1 billion. Part of that, or a chunk of that, really are US Experience of the Future projects. We've substantially reduced those projects for this year.

Now, to your point, I view that as, as soon as it's reasonably feasible, to keep going on those. Many of the franchisees will want to continue doing those. We have gotten some requests even already for some franchisees to continue those projects. So I would expect a lot of those would get pushed into 2021, but I think the franchisees, and rightly so, want to understand that the business is back to operating, I'll say, more normally before they go invest substantial dollars and close their restaurants for a period of time also.

So that's a piece of it. We're also reducing openings in many of the markets outside the US, again partly because if you think about several of those countries, they've been closed for a period of time now. They're just getting back up and running now, the normal operations. And so, the disruption of going and opening new restaurants right now at a maybe quicker pace, probably isn't the right thing to do for a lot of the franchisees there. So that

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pace will slow in 2020. But, again, I think that's relatively easy to continue picking up. And we certainly still see opportunities for growth in most of those markets, so it isn't a long-term change in opportunity, but it is a pause in 2020 for a lot of that.

Mike Cieplak
Corporate Vice President-Investor Relations Officer, McDonald's Corp.

A

Our next question is from Nicole Miller Regan with Piper Sandler.

Nicole Miller Regan
Analyst, Piper Sandler & Co.

Q

Thank you. Good morning. I wanted to ask about the limited menu and streamlining that. Clearly for a different reason today, but I think of, in some cases, where you have been doing that as a strategy, thinking of a Paris, in particular. So how permanent might this be and even if it's not, what are the learnings? And then, if you could please just clarify for the US, the daypart mix prior to this current situation, what it is now and then if you expect it to be different going forward. Thank you very much.

Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Hi, Nicole. Yeah, so I guess just I'll take the easy one first, which is, breakfast is down relative to the other dayparts and that's consistent with everything we've learned. It's consistent with what we've seen in markets like China. It's consistent with what we've learned through the whole Experience of the Future, closing and then reopening process. So breakfast is down relative to the other dayparts that we ordinarily have.

And then, the...

Kevin M. Ozan
Chief Financial Officer & Executive Vice President, McDonald's Corp.

A

Limited menu.

Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Yeah, and limited menu, it's been interesting and it's a good question. So we have gone to limited menu in the US, as well as a number of other markets. I think one of the things that each of the markets are thinking about is, as you go back to more of a standard menu, do you immediately revert back to sort of everything that was on the menu or does this maybe provide us an opportunity to do some things that get that balance right between margin, operationally, speed of service, et cetera.

So I think it's probably safe to say at this point that that is going to be a market-by-market decision, but I would say every market is thinking about does it make sense to go all the way back to where we were pre-crisis, or maybe we want to go back in more of a staged way and add some items but not all items. So stay tuned on that.

Mike Cieplak
Corporate Vice President-Investor Relations Officer, McDonald's Corp.

A

Our next question is from Katie Fogertey with Goldman Sachs.

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Katherine Fogertey
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thank you and hope everybody is well. I wanted to dive into the breakfast point in a little bit more detail. We heard from a smaller competitor of yours yesterday that the franchisor is going to be allowing franchisees to take breakfast off the menu if it makes sense, and there's a lot of competitive dynamics right now within that daypart.

So was hoping you could contextualize the opportunity you see there and the competitive landscape and how you are thinking about the economic sensitivity of breakfast, any disruptions around people's normal routine and how you're prioritizing marketing to hopefully recapture that as people return back to work. Thank you.

Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Sure. Well, I think it's fair to say breakfast is a critically important daypart for us. And so we are, as we start to really get into the recovery phase, getting back that breakfast business is going to be critical for us. I think the point we were trying to make on breakfast is it takes time. It's a disruption to routines. Reestablishing those routines does take time, but we plan to be very aggressive and make sure that we get back the breakfast business. The breakfast business is a great part of our overall mix, and so we're going to be putting a lot of effort against that.

Mike Cieplak
Corporate Vice President-Investor Relations Officer, McDonald's Corp.

A

Our next question is from John Ivankoe with JPMorgan.

John Ivankoe
Analyst, JPMorgan Securities LLC

Q

Hi. Thank you. There are some comments that were made regarding perhaps changing the way that we operate, I think is the words that you used, some potentially further change that's coming in the relatively near term. I assume – or perhaps that's alluding to G&A and just the overall structure. And, obviously, Chris, I think you were going to go through this exercise as a new CEO regardless, but how you feel about organizational structure or spend, offices, reporting lines, what have you, and if this is kind of a catalyst to maybe make some changes over the near term that you could have potentially considered over the much longer term?

Chris Kempczinski
President, Chief Executive Officer & Director, McDonald's Corp.

A

Yeah, I think our comments around how we operate has really been – was geared more toward how we operate the restaurants, and the changes that we need to make as we're in the midst of this crisis, how many of those stay permanent. So I think the intent was really when we talk about how we think about things operating differently, it's about how our restaurants operate differently after that.

Your other point, though, which we did talk about is – and, as I mentioned in my remarks, the world is going to look different coming out of this crisis. And we expect that many of those changes are going to be enduring. And so, part of the work that we're going through is really thinking about our strategy kind of in this post-COVID world.

We've got a great foundation to build on with Velocity Growth Plan, but I think it's probably fair to say that we're not just going to pick up the Velocity Growth Plan playbook and kind of resume business as usual. There are going to need to be adjustments to that. And so, my team and I are planning on doing that work over the next

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several months. As we start to formulate our point of view and determine what continues, what changes, we'll come back to all of you later in the year and give you more insight into that.

Kevin M. Ozan
Chief Financial Officer & Executive Vice President, McDonald's Corp.

A

The only thing I'll add on G&A, John, is we are certainly reviewing our investments. We're reducing or delaying some spending, reallocating some resources. So I think we're doing the things that people would expect us to do as far as certainly scrutinizing our spend. But, at the same time, we also have – as I mentioned, we have a few kind of nonrecurring costs. We have the cancelation of our worldwide convention that cost us about $40 million. We have some contractual obligations we needed to pay for, stopping some R&D work that cost us about $20 million.

And then, we also have an unusual dynamic where there's a portion of our people costs that are capitalized related to restaurant openings. And as we reduce our restaurant openings, less of those costs will be able to be capitalized. That will likely cost us another $30 million to $35 million of G&A. Now that's not additional cash because we were paying those folks already, but it's the accounting of them where it may end up in G&A, instead of where it would've been capitalized on development. So we've got some offsetting things going on in G&A for the year.

Mike Cieplak
Corporate Vice President-Investor Relations Officer, McDonald's Corp.

Thank you, everybody, for joining us. That'll conclude the call. Have a good day.

Operator: This does conclude McDonald's Corporation investor conference call. Thank you for participating. You may now disconnect.

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