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McDonald's Corp. (MCD)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello and welcome to McDonald's Second Quarter 2019 Investors 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, Steve Easterbrook; and Chief Financial Officer, Kevin Ozan. Today's conference call is being webcast live and is also being recorded for replay on our website.

Before I turn it over to Steve, I want to remind everyone that the forward-looking statements in our earnings release and 8-K filing also apply to our comments. Both 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.

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

Stephen J. Easterbrook

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

Good morning. We're pleased to be speaking to you today from our corporate headquarters in downtown Chicago, where we recently celebrated our one-year anniversary in this contemporary urban facility. Returning to Chicago was a deliberate move to get closer to our customers and the trends shaping business and society today. Our new facility was designed to be a modern and inspiring environment, a catalyst for our evolving culture. Our move is also a metaphor for the momentum we're seeing across our business, momentum that has been building since we first launched our turnaround plan.

As we've recently passed the four-year mark, I thought it would be important to spend a few minutes reflecting on our journey. Back in May 2015, I announced our initial steps to reset and rebuild our business, including our three-fold priorities of driving operational growth, returning excitement to our brand and unlocking financial value.

At the time, we were keenly aware that the pace of change inside McDonald's was being eclipsed by the pace of change outside our business. We knew we had to evolve with our changing market and consumer dynamics, and we knew incremental progress wasn't going to cut it. Returning to a growth company was going to require big, bold steps and greater personal accountability. We knew success would be determined by the fast beating the slow, by choosing progress over perfection and moving with a sense of urgency. So we set out on a journey to become faster, smarter and more responsive to changing consumer expectations.

We restructured to be closer to customers and faster at the point of impact. We refranchised to drive growth and bring greater insights at a local level. We increased accountability and financial discipline and returned cash to shareholders. Most importantly, we returned to operating growth. Indeed, within two years, we established a

strong foundation, one that was fit for purpose and brought the business to a place where we could begin accelerating growth again.

That led to the launch of our Velocity Growth Plan in March of 2017. The plan is rooted in building on the fundamentals that have served our company so well for over 60 years. It's about running better restaurants, offering a compelling menu of delicious and affordable food and complementing that with hospitality and convenience for our guests.

We know that when we create delicious, feel-good moments for customers, every visit, every day, customers recognize our efforts and reward us with repeat visits. We also know that we must continuously complement that work with big and powerful moves that keep us relevant and inviting for new generations of guests. We deployed three accelerators to help us do just that: our Experience of the Future, or EOTF; digital; and delivery.

With these efforts, we are focused on actions that have the biggest benefit to the most customers in the shortest possible time. That's the path to becoming a better McDonald's. Four years in, we did the hard work to put the Velocity Growth Plan and accelerators firmly in place, and we are energized by the broad-based strength in our results.

For the quarter, global comparable sales increased 6.5%, which marks four full years of quarterly comp sales growth. This was complemented by positive global comp guest counts.

During the quarter, we made strong gains in running great restaurants. We still have work to do. Because speed of service is so important to our customers, seconds matter and impact decisions they make on repeat visits. We're leveraging the power of the system, franchisees, suppliers and employees to reduce menu complexity, improve operational procedures, deploy new drive-thru crew competitions and incentives, adopt best practices for staffing and leverage new technologies to make it easier for our teams to take responsibility for performance. And we're encouraged by the results we are seeing.

We set market-level targets early this year and have dropped service times across many markets globally. We're providing a better experience for our customers and, with that, seeing record-high customer satisfaction scores this summer.

Here in the U.S., the plan we built with our franchisees is ambitious. Collectively, we recognized the need for change and knew it would be hard work. We spent 2018 deploying major initiatives, including a new value platform, fresh beef, delivery, EOTF modernization and the restructuring of U.S. field operations.

At the beginning of this year, we said 2019 be a year to execute on running better restaurants and optimize the initiatives we deployed last year. In restaurant visits with franchisees around the country, I'm seeing the results of focused execution against the plan. Importantly, average franchisee restaurant cash flow has grown eight consecutive months through June, fully overcoming the decline we saw in 2018.

Across our International Operated Markets, or IOM, we're seeing continued success. Consistent execution against the Velocity Growth Plan is a winning formula.

I had the pleasure to visit Italy during the quarter and witnessed firsthand the rigorous focus on operational innovations and improvements. Italy now has posted 10 consecutive quarters of comp sales and guest count growth, with double-digit comp sales and guest count growth for the quarter. In fact, Italy has outperformed the local informal eating out, or IEO, category for nearly two years now.

I saw similar energy and focus when I went from Italy to Poland, which also posted strong comp sales and guest count growth for the quarter. This high-performing market was an early adopter of EOTF and digital. In Warsaw, I saw the positive impact our Guest Experience Leaders have on hospitality, as they greeted customers with a special warmth that made guests feel welcome.

Italy and Poland are great examples of markets where we start the best practice and replicate it at scale across other markets. Whether around EOTF rollout, hospitality, operations, or digital, ideas originate in one market and rapidly move to another, creating an environment where all boats rise.

Now, let me turn it over to Kevin for a deeper dive into our comp sales trends by market and performance drivers.

Kevin M. Ozan

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

Our top-line momentum remains strong. As Steve mentioned, global comp sales increased 6.5% for the quarter, with each operating segment contributing meaningfully to our growth.

In the U.S., comp sales were up 5.7%, our highest comp sales increase since the launch of All Day Breakfast back in the fourth quarter of 2015. And once again, we also grew comp sales across all dayparts.

Performance drivers for the quarter included proven value in deals such as our national 2 for \$5 Mix & Match promotion, featuring our core menu items, as well as other locally relevant offers.

Our renewed focus on our iconic core menu resonates well with our customers. Since switching to fresh beef for our quarter pound burgers just over a year ago, our sales results and positive customer response confirm it was the right strategic move.

In the first half of 2019, we sold over 55 million more quarter pound burgers compared to last year. A combination of both deal offers and line extensions, featuring bacon and deluxe builds on our classic Quarter Pounder with Cheese, helped to boost sales.

Similar to last quarter, the sales benefit from our modernized EOTF restaurants contributed to our overall U.S. comp performance, which we expect to continue for the remainder of 2019.

By taking learnings from completed projects, we've successfully reduced construction downtime. And we're also recovering sales quicker after reopening.

During the quarter, we converted an additional 600 restaurants to EOTF, for a total of 1,000 projects completed in the first half of this year. We still expect to complete a total of about 2,000 projects for the full year.

Strong average check growth from both product mix and pricing continues to fuel our top line in the U.S. We're seeing success with offerings that increase average check, traffic and cash flow, such as our current Worldwide Favorites LTO. However, returning to guest count growth in the U.S. remains a top priority in the street fight for market share.

Turning outside the U.S., strong balanced results continued across the International Operated segment, with comp sales up 6.6% for the quarter. Each of the markets within the segment grew comp sales, and nearly all of the markets also grew comp guest counts.

Strong results in the UK, France and Germany were key contributors to the segment's growth. The UK marked its 53rd consecutive quarter of comp sales growth and increased market share versus our competition across all dayparts. Maximizing delivery was a key success factor for the market, along with menu innovation, such as the Bacon Roll breakfast sandwich and the Tastes of America burgers LTO.

France has been successful with both its premium and core burger offerings, balanced with a compelling value platform, helping the market to again achieve record high market share. France now has nine consecutive quarters of both comp sales and guest count growth.

And Germany is maximizing contributions from EOTF, our core menu and strong value messages, all of which resonate with their customers. Germany also gained market share versus competitors and customer satisfaction scores are up.

In the International Developmental Licensed segment, comp sales increased 7.9%, with sales in guest count growth across each geographic region within the segment. Results across our three largest markets drove the strong sales performance, with double-digit growth in Brazil, strong comps in Japan and positive performance in China. Accelerated new restaurant growth by our strategic partners, primarily in China, led the segment to grow system-wide sales by 10% for the quarter in constant currencies.

Now I'll turn it back to Steve to further discuss the growth accelerators driving our global business.

Stephen J. Easterbrook

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

Over the past four years, we've seen unprecedented changes in the global consumer landscape. With this proliferation of change, consumers today expect more from us. Quality, service and convenience are more important than ever. And, of course, delicious food served by welcoming people is absolutely essential.

The accelerators of our Velocity Growth Plan are all about giving our global customers more control over how they order, how they pay and how they're served their food.

In the U.S., we've made significant progress in modernizing our restaurants through our Experience of the Future initiative. We have now modernized over 8,500 U.S. restaurants. Today, customers are much more likely to visit an EOTF restaurant than they were just a year ago.

At the end of May, I was honored to join our team in New York for the opening of our new Times Square restaurant. Our three-story restaurant is a major brand statement on how we're providing a better customer experience through decor, enhanced customer service and seamless order and pay technologies.

Our major IOM markets have had Experience of the Future for some time and we're continuing to unlock its potential. For example, in Australia and our major European markets, over 40% of in-store customers now use kiosks when dining with us, taking control of how they order, customize their food and select how to be served. From New York to Sydney, and most places in-between, our restaurants are not just ready for the future, they're meeting customers on their terms, today.

Delivery is another area where we're taking bold action to meet customers' expectations for high-quality food, on their terms, with increasing demands for convenience and speed. We've made significant progress on delivery the

past two years and have room to grow in a largely untapped market with great upside. Driving customer awareness and trial about McDelivery remains a top priority.

Globally, we expect delivery to be a \$4 billion business in 2019 for McDonald's and franchise restaurants. Across our major markets, we've maintained double-digit delivery sales growth in restaurants offering the service for more than 12 months.

In the UK and Spain, delivery now accounts for greater than 10% of sales in restaurants that offer delivery. In the U.S., McDelivery with Uber Eats is now available in more than 9,000 restaurants, which is more than half of all McDonald's U.S. restaurants.

We're also continuing to add new partners that allow us to scale and deploy delivery to meet untapped customer demand. We recently announced a partnership in the U.S. with DoorDash to expand the availability and accessibility for customers to receive our delicious food wherever they are. We will quickly scale with DoorDash across the U.S. to provide customers with a choice of delivery partners.

In Canada, we have seen incremental strength in delivery with our second national partner, SkipTheDishes. We offer delivery in 850 restaurants in Canada, many of which offer delivery from both partners. Multiple delivery partners now are also the norm in Italy, Spain and Russia, where we're learning from our partners whilst driving increased delivery orders.

We're also taking bold action on digital. Since closing the Dynamic Yield acquisition in April, we launched the decision logic technology on digital menu boards in drive-thrus across multiple regions in the U.S. Customers have responded to the point-of-sale suggestive selling by adding French fries, drinks, Chicken McNuggets and other favorites to their orders. We're already seeing an increase in average check by improving our ability to offer customers what they are likely to want, with suggestions based on time of day, weather and items already in customers' orders.

We introduced Dynamic Yield technology in Australia this month and will increase the number of drive-thrus in the U.S. using the technology from about 700 today to over 8,000 in the next two weeks. By year-end, we plan to integrate the technology in nearly 100% of our drive-thrus in both markets. This is another example of using technology to create more engaging experiences for our guests.

The technology infrastructure we've built over the past three years to support our Velocity Growth Plan and accelerators is fundamental to our transformation. It's a reflection of what our customers demand from us and it's not static. Digital capabilities change by the day and impact what customers ultimately expect from us. The technological ecosystem we're building will enable us to meet these rising expectations, positioning us for new opportunities to elevate and transform the customer experience.

Now, I'll turn it back over to Kevin for a look into the financial results for the quarter.

Kevin M. Ozan

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

Adjusted earnings per share of \$2.05 grew 7% in constant currencies for the quarter, when excluding impairment and other strategic charges from both the current and prior years. Our results benefited from strong operating performance for the quarter. Revenue grew 3% in constant currencies, as our comp sales growth more than offset the impact of refranchising activity.

Adjusted operating margin for the first half of the year was 43.2%, an increase of 30 basis points versus last year. As a result of our refranchising efforts over the past few years, the largest component of operating income is our franchise margin dollars. With growth of 9% in constant currencies for the quarter, franchise margin dollars now represent nearly 85% of total restaurant margin dollars.

Our consolidated franchise margin percent declined 100 basis points, as our strong sales performance was impacted by higher EOTF-related depreciation in the U.S. as well as 70 basis points from the lease accounting presentation change that I discussed last quarter. As a reminder, this presentation change has no effect on our franchise margin dollars, but the impact to our franchise margin percent will be ongoing.

Turning to our company-operated restaurants, consolidated margins grew 20 basis points to 18.1% for the quarter. IOM segment company-operated margins were flat versus prior year, as our strong sales performance was offset primarily by higher labor and other costs, such as delivery commissions. U.S. company-operated margins grew 40 basis points to 16.3%, reflecting strong sales performance and refranchising, partially offset by continued commodity and labor pressures, along with higher EOTF-related depreciation.

Second quarter pricing for both the U.S. and the big five markets in the IOM segment was up about 2.5%, while commodity costs were up a similar amount across these markets. In the U.S., we expect commodity pressures to ease somewhat in the back half of the year and still expect our grocery basket to be up 2% to 3% for the full year. For the big five markets in the IOM segment, we expect the full year commodity cost increase to be up roughly 2.5%.

G&A was 2.1% of system-wide sales for the quarter, and flat to prior year in constant currencies. We still expect G&A for the full year to remain relatively flat in constant currencies versus last year, as we continue to invest in digital and technology capabilities.

Our effective tax rate was 24.5% for the quarter. And we continue to expect a full-year tax rate between 24% and 26%.

Foreign currency translation negatively impacted our second quarter results by \$0.07 per share, given the strength of the U.S. dollar. At current exchange rates, we expect the foreign currency impact to lessen to \$0.02 to \$0.04 for Q3, with further easing into Q4. Our estimated full-year headwind remains at \$0.18 to \$0.20. As usual, this is directional guidance only because rates will change as we move through the year.

Now, I'll turn it back to Steve.

Stephen J. Easterbrook

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

I'll begin my remarks this morning by talking about momentum. The momentum we're building is apparent to our customers who seek the convenience and value of McDonald's great-tasting food. It is apparent to our people. It's apparent to industry observers who are watching our transformation. Getting to these results wasn't easy and we need to continue to work hard to sustain performance as we face macroeconomic and industry uncertainties around the world. While we remain confident in our strategies, customers are rewarding us for the investments we are making to offer them great-tasting food, a modern and hospitable environment and unparalleled convenience.

We all want to be associated with: companies, organizations and brands that engage and inspire us; brands that are inclusive, fun, relevant and successful; brands that strive to improve communities and societies at large. That's where we're headed as we continue to unlock the potential of the Velocity Growth Plan and its

accelerators. And it is why you'll see us continue to focus on our innovation and technology pipelines. This is our version of success.

We're building a better McDonald's through: a culture of innovation, focused on a better customer experience; a culture that strives to make the jobs of restaurant employees easier; and a culture that is focused on sustaining long-term growth. This is our mindset as we push ourselves to execute our Velocity Growth Plan and accelerators with a strong sense of urgency, passion and commitment.

With that, we'll open it up for Q&A.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions]

Mike Cieplak

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

Our first question is from Andrew Charles with Cowen.

Andrew Charles

Analyst, Cowen & Co. LLC

Great, thanks. Steve, could you put a little more context to the mix growth in the U.S. that seems to be accelerating, certainly outperformance outside the lower ticket breakfast occasion if that's continued, as well as lapping Dollar \$1, \$2, \$3 from last year helps. But I think investors are wondering about the endurance of the customers' ability to pay up, absent any growth in traffic. Relatedly, the most tangible driver may be Dynamic Yield as we look forward. In the 700 stores that have added the initiative so far, have you experienced a consistent lift to sales, particularly on mix, once the drive-thru adds the initiative or has the lifts to sales been more varied? Thanks.

Stephen J. Easterbrook

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

Thanks, Andrew. As you say, clearly, this is a check-driven sales comp growth in the U.S. What I think is encouraging for us and gives us confidence that we've got more sustaining platforms is the balance of how that check is built. So we're about two-thirds is through product mix and one-third through price. So I think that's a fairly healthy balance. When you kind of drill into it, I mean there's a number of elements at play here that's helping with this.

So if we just look at some of the menu activity and promotional activity through the quarter, for instance, there was a good local co-op initiative, which many of the local co-ops initiated, particularly through Easter period, on the Filet-O-Fish promotion, which gave us an incremental lift. We've been pleased with the way the Worldwide Favorite promotion has worked. And that's meeting or maybe even slightly exceeding our targets, and it's giving us incremental business.

As we continue to innovate around the kind of the hot off the grill platform, the Quarter Pounder Cheese with different options around lettuce and tomato, that also works, along with we actually got a nice lift on the Happy Meal business, particularly now we've reestablished the relationship with Disney. So I think there's a number of

elements through just the menu and marketing piece that have given us – building on platforms that has taken us a while to invest in or operationally embrace, but is now beginning to deliver more consistent results.

Also, we're seeing as we convert the EOTF restaurants, we're getting an incremental sales lift from that, some of which will come through growing and increasing use of the self-order kiosk, where we generate higher average checks, as we've mentioned before.

Alongside delivery – don't forget delivery, remember. Bear in mind, as that becomes a larger part of our business, we're still seeing about twice the average check on the typical delivery order as well. So there's a number of contributors. It's not a one single contribution. If you look through right across the business, I think it's the culmination of a lot of the initiatives that we've been investing in the last two or three years are beginning to come together, which is giving us encouragement.

On Dynamic Yield, we've been really pleased. I've got to say, sort of three months in, couldn't be more pleased with the integration of Dynamic Yield, both as a company and as a culture but also, frankly, getting the capabilities into our restaurants. So we've been running 700 restaurants now for the best part of 2.5 months. We're seeing consistent trends across different dayparts, across different days of the week, across those 700. And that's certainly encouraged us with the support of our Owner/Operators, of course, to quite significantly accelerate the rollout.

We know the technology works. We can plug it into our existing outdoor digital menu board. So we're going to go from about 800 now to 8,000 by this time in two weeks' time, which is fantastic. And we would expect to see – we have no reason to believe that the kind of lifts we're beginning to see – and I'm not going to go into those details, but the kind of lifts we've seeing at the moment, we would expect to continue across, obviously, the accelerated rollout.

What's also been really encouraging to us, whilst we're on the subject of Dynamic Yield, we've taken it into our first international market and have gone very, very, quickly from about 20 restaurants to 150 in Australia. The reason that's important is because – and I don't want to get too much into it, but the content management system, kind of the brain which holds all the data, which Dynamic Yield's product works off to then produce what we can show on the digital menu boards. Internationally, they have one typical content management system and the U.S. has another.

And we've been able to prove very, very quickly that the technology works on both platforms, which really indicates this is ready for a global expansion. So we'll be careful that we don't get over our skis on it, but the pull from the markets is strong and the excitement from the Owner/Operators is great.

And the most probably rewarding, or one of the most rewarding elements as well as the business results, is it just makes the managers and crew life easier in the restaurant as well, and the order-taking process a little quicker, because we don't have to manually suggestive sell, the technology does it for you.

So that was a long answer, but plenty, a wide variety of initiatives are helping support that. And not least, by the way, just the fact that we're actually running the restaurants better. The focus we've got on the drive-thrus, which I spoke about in the last quarter, we're seeing drive-thru times drop in almost all of our major international markets and notably here in the U.S. as well. So I can talk maybe more about that later.

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

A

Our next question is from David Tarantino with Baird.

David E. Tarantino

Analyst, Robert W. Baird & Co., Inc.

Q

Hi. Good morning and, Steve, I guess while we're on the subject of speed of service, I just wanted to ask, I guess, at the opening remarks, you talked about having a philosophy of not focusing on incremental change, but focusing on more step changes in your overall strategy.

So I'm just wondering if there's something on drive-thru speed that can accelerate the progress you're seeing. It seems like it's been fairly shallow so far, but perhaps I'm mistaken on that.

And then maybe one clarification at the end, I just wanted to understand the traffic decline in the U.S. in Q2. Did that change from what you saw in Q1? Or did it remain around the same level? Thanks.

Stephen J. Easterbrook

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

A

No, that's great. Well, let me take the drive-thru one. Once a year, we get our leaders from around the world together, so probably 60, 70 strong, including the managing directors of our top 20 markets. And we got together the start of March.

And whilst, clearly, it's been a really strong performance across the last three to four years, there are certain areas where we know we need to do better. And we kind of had a whites-of-the-eyes conversation at the start of March. And we collectively agreed that we were going to renew some emphasis on the drive-thru service times. They've been going the wrong way in most of our markets for three or four years for reasons we could understand, as we've added more to our business. But we knew that wasn't a sustaining trend.

So when you talk about progress in the drive-thru, I mean, frankly, it will improve. We want to get incremental improvement week-to-week-to-week, so that each time a customer comes back, say, a week or two later, they can notice a few seconds difference.

There's been a ton of things we've done. We've had some centrally-led initiatives, but also some market-led. I mean, all this stuff from some of the menu simplification moves that you would have read about, particularly here in the U.S., where we streamlined the late night menu, removing of the Signature Crafted, which was slowing down service times, and giving some of the local co-ops a chance to roll back some of the All Day Breakfast rollout, kind of the second phase. So those things just helped smooth the operation in the kitchens.

But we also are introducing, increasingly introducing, technology and diagnostic tools that our managers and crew can see in real-time in the drive-thru lanes. They can basically decompose the various elements of a drive-thru visit for a customer into its constituent seconds.

So how long are we taking to take the orders? How long are we taking to take their payment? How about how long it takes us to gather their food and present it? How many cars are we asking to pull forward and then bring the food later? And just with that attention, we're beginning to see notable changes.

So it clearly kicked off really by the start of this quarter. Just to give you a slight sense of what we're seeing already, in June, for example, in the U.S., we saw a 15 second reduction year-on-year in service times in the drive-thru, which I would say is more than incremental. I mean, that's notable. And clearly, that's rewarding for customers because it's a smoother journey. It also helps us with throughput as well.

So I mean, there's certainly a lot more to do, but I'm really encouraged. And there's certain other international markets that are seeing double that type of reduction with the focus they're putting on. So there's more to come.

Kevin, you may want to talk a little bit to traffic divides.

Kevin M. Ozan

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

A

Yeah, David, regarding guest counts in the U.S. in the second quarter, I'd say there wasn't a meaningful change in the underlying guest count trend in the U.S. The actual number for the second quarter was, I'll say, less negative than the first quarter.

But there were some specific things in the second quarter, some of which Steve mentioned earlier, things like there was that calendar shift with Easter timing this year versus last year, that a little bit benefited the second quarter. As Steve talked about, the Filet-O-Fish, we had about 70% of our co-ops that offered a Filet-O-Fish deal in Q2. That helped drive some sales and guest counts. And then Worldwide Favorites, obviously, was an LTO that helped the second quarter, too.

So while the actual number was less negative in the second quarter, I'd say there really hasn't been a meaningful change in the underlying trend.

Mike Cieplak

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

A

Our next question is from Jeff Bernstein with Barclays.

Jeffrey A. Bernstein

Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much. Just following on that, one clarification, if you could just provide some color on the breakfast side of the business in the U.S.? I got the impression last quarter that you were keen to see that breakfast had turned more favorable. I'm wondering if you can talk about whether there was any accelerating momentum in the quarter, kind of where it stands as a percentage of sales, and maybe how breakfast compares to the rest of the day?

And then I just wanted to ask one other thing. Should we expect, Kevin, an update on the return of cash targets as we now finish out 2019? Are we going to get another, kind of, three-year bucket as we look out to the next few years? Or how should we think about the outlook for that going forward? Thank you.

Stephen J. Easterbrook

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

A

Hi, Jeff. I'll take the first one. We did see a better trading performance in the breakfast daypart in quarter 2. I think the combination of local activity with the local co-op support, plus we did see some strong results out of the McCafé initiatives and the Donut Sticks that we launched in the first quarter as well. So on the daypart, we grew sales. It was still the slowest growing daypart amongst the day, but it was back to a solid sales growth. There is still guest count decline, as I think we mentioned before. There's plenty of other entrants who are competing in the breakfast market. We don't have it all our own way, the way perhaps the way we used to back in the day. So it remains competitive. We've got sales growth. We're encouraged by that, but we know we've got more work to do.

Kevin M. Ozan

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

A

And regarding the return of cash targets, so as you know, this year we'll complete our three-year, \$25 billion target. We're on track to do that. So we'll finish that this year. Later in the year, then, we'll provide an update as far as what that means going forward beginning in 2020.

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

Hi. Thanks. Good morning. Can you update us maybe on the U.S. franchisee relationships, in particular I think you slowed down the EOTF rollout in concession to them, but now you're talking about profits for eight months rising. Is there a greater enthusiasm to embrace this maybe and pull forward some of the things you talked about in 2021 and 2022 and get it done faster? Can you also talk about maybe where they stand or where you stand on delivery? I think there was friction around commissions, and sort of the economics of that? Have you resolved some of those issues? And I think there was some adjustments you may plan to make in the back half, just what those adjustments to royalty or rent relief are associated with that? Thanks.

Stephen J. Easterbrook

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

A

Yeah, thanks, John. As I've said before, 2018 was a really hard work year. I mean, both the Owner/Operators and the company invested a lot of time, a lot of effort and a lot of money in really kick-starting the Bigger, Bolder Vision as the plan they built. And that does create tensions at a point in time and that's natural. We worked our way through them. I would say that by easing off the speed of the EOTF gave those Owner/Operators who wanted a bit of breathing room were able to select that and push one or two projects out, which gave them a lot more confidence and comfort.

That said, the results we're getting from the EOTF rollout are really strong and they're very similar to what we've seen elsewhere in the world. So you'll find the majority of Owner/Operators are sticking with the original plan, accelerated plan really to complete their businesses by the end of 2020.

It will be optional for Owner/Operators to pull their projects forward, if they want to in 2021, there's 2022. They're welcome to. We'll be ready for it. I think what it has also given us is – we're a wonderful learning organization as a system. We're always striving and curious to get better. And if we look at the performance of EOTF, just as an example because you mentioned it, the downtime of the projects, we're about two to four days better this year than we were in 2018, which clearly helps get the business back on track.

The time to recover the sales, as in when you reopen and getting yourselves back up to the levels, that recovery time is quicker. And also the dip during the closure is a little less this year than it was last year. So I think our execution around these 2,000 projects this year is sharper, but probably those three elements, which again builds confidence in the Owner/Operators that this is going to be a strong business outcome for them.

With delivery, yeah, we are clearly keen to roll this out. The Owner/Operators know this is a great business opportunity. We have around the world, worked with our Owner/Operators in each of our markets to find an

arrangement with them as to how we can best take some of the heat out of the commission costs that they face in order to make it encouraging.

We want them to make money out of it. And we, as a company, will make money as a result. So, I think we're in a far better place. I think probably the two indicators just here in the U.S. that will demonstrate the confidence the Owner/Operators have is that once we settled on this new rent arrangement with them, I think it was within about a week they voted on a national marketing campaign with Uber Eats to put marketing dollars behind delivery, and the eagerness with which they've embraced the second third-party operator being DoorDash. I mentioned in my opening comments we've got around 200 restaurants in Houston on DoorDash at the moment and that's just really making sure we can integrate the technology and get the operation right.

By the end of August, we're going to have probably two waves of around 4,000-plus restaurants, so we'll be up at about 9,000 on DoorDash by the end of August. Again, just showing you the speed we're going and, hence, the Owner/Operator commitment behind it, and we've got already about 9,000 with kind of our key strategic partner, which is Uber Eats.

There's not perfect cross-over. There's going to be about an additional 1,200 restaurants that have either one or other, depending on coverage. That means that we've got about 8,000 which will have two third-party operators. And we've seen, around the world, that does give us good incremental delivery business. Customers are typically, not solely, but typically, loyal to one third-party operator app. So we know what we've seen from Canada when we added SkipTheDishes to the Uber Eats platform.

We've also seen it elsewhere around the world, such as in Italy, where we've got three, where we've got Glovo, Deliveroo and Uber Eats. So we've got good experience of working multiple delivery partners and we're confident the incrementality will come with it and then, as a result, the cash flow to the operators.

But ultimately, the mood of the operators, I think, are feeling much more confident. By May of this year, their cash flow growth eclipsed the decline that they saw in 2018. So, as you can imagine, that gives people a great sense of satisfaction. June continued that. So we've now got eight months in a row of cash flow growth. And we're confident and committed to maintaining that trend for them because they committed a lot to this plan. They commit a lot to our business and we want them to build business wealth and success.

.....
Mike Cieplak

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

A

Our next question is from Greg Francfort with Bank of America Merrill Lynch.

.....
Gregory R. Francfort

Analyst, Bank of America Merrill Lynch

Q

Hey, thanks for the question. Just maybe going back to the drive-thru times, can you quantify how much those were up? And then, I guess the question is how much have you recaptured with the 15 seconds, what percentage of what you have seen in an increase the last few years? And then, how much opportunity do you think there is going forward? And what's the key strategy to address that? Is there changes you have to make on the product front or menu front to kind of capture more time savings? Thank you very much.

.....
Stephen J. Easterbrook

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

A

I'm not going to get into all the details of drive-thru service. They do differ by country as well obviously, depending on how busy the drive-thrus are. I mean, we've got certain markets in Europe where drive-thru's only about 40% of the business of a drive-thru restaurant, whereas here in the U.S., it can be upwards, 70%, 75%. So that creates a totally different service time dynamic.

I would say across the major markets, as we sat down in March, we wanted to set ourselves that by the end of the year to be about 30 seconds better, which we knew would be noticeable enough to be noticeable to the customer and also then business enhancing as it eases up throughput. And particularly at those peak service times obviously, that's the most critical time to do it.

There's a number of different initiatives to it. I mean, some is just getting the focus. I mean, understandably with the aggressive rollout of Experience of the Future, there was a heightened focus in store front counter dining area. We're just rebalancing that. So some of it is just the focus on the drive-thru, people positioning, making sure we're staffing right, training and the basics.

But there are certain things, for example, on menu. And I think we've got a far more forensic ability through our sort of global operations team in our Innovation Center now to analyze the complexity of our menus by market and identify those slower-moving items that really are not contributing much to incremental margin and certainly not selling in many volumes, but create barriers to service. So I think those diagnostic tools and the forensic tools we have now is providing the information into each of the markets so that they can make smart menu decisions. But it's not just about the menus, around technology as well and actually just making it fun.

I mean, we've had a number of service competitions around all the markets, and particularly now we've given these tools to the restaurants, to the managers. When I first saw the drive-thru [ph] timer tools (45:23) in Canada probably 12 to 18 months ago and then saw them rolled out in Europe probably about 12 months ago. They're in the majority of the U.S. drive-thrus now. Probably what captured my attention more than anything else was the enthusiasm the managers and the crew had for that kind of local competition. How are you doing versus the drive-thrus in your area or the drive-thrus in your Owner/Operator group or the drive-thrus of a similar volume to you.

So we can use these tools in many ways to A, identify where the barriers are, but actually just make it fun, incentivize and get the enthusiasm of the managers and crew, so more to come. I'm encouraged with where we're at. We've got some markets, which are actually, 30, 40 seconds quicker now just three or four months in. So they've got a bigger opportunity than some, but they're making good headway. And the U.S., I'm proud of where the U.S. is at. I know they're focused on getting better than the 15.

Mike Cieplak

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

A

Our next question is from Dennis Geiger with UBS.

Dennis Geiger

Analyst, UBS Securities LLC

Q

Great. Thanks for the question. I wanted just to ask a bit more about the U.S. guest counts, maybe if you could just highlight a bit more where you're seeing progress and where the biggest opportunities are to continue to show that improvement. And then, I guess, within that context, Steve, I think you've talked in the past about a growth strategy to retain customers, regain customers and convert casual customers. Any update there you could give specifically on the converting the casual customer, and if that's still how you're thinking about getting that guest count up in the U.S.? Thank you.

Kevin M. Ozan

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

A

Yeah, Dennis, it's Kevin. I'll take a stab at that and Steve can chime in. As far as progress or opportunity, I think as we've talked about, certainly one of our biggest opportunities continues to be at breakfast. As Steve talked about, there's been a lot of new entrants into that space, so there's not many players that are growing comp guest counts at breakfast or really in most of the dayparts. But new entrants have kind of caused a scattering, I'll say, of the existing guest counts among just more units.

As far as retain, regain, convert, the convert strategy for us was always around kind of opportunities in either other dayparts or other areas that we didn't have our fair share, if you will. So areas like coffee and snacking and areas that are potential further growth opportunities, but we are not as strong in some of those areas. It wasn't necessarily taking some of our existing customers and just having them come more frequently. So there still are opportunities in some of those areas, again like coffee and like snacking.

I think the way we think about it is there's an opportunity, and this is what kind of one of the purposes of both EOTF and our digital is to take our existing relationship with customers and expand that relationship through digital means, whether that's through apps, a further loyalty program at some point, but the whole customer relationship where we can get to know and personalize offers easier and better for existing customers. That's one of our big opportunities.

The U.S. guest counts will continue to be a – we call it a street fight just because it's a very competitive environment here in the U.S. But I think there is more of a focus on what do we need to do in the various dayparts; again, breakfast probably being the biggest opportunity for us to regain some of those guest counts that we lost. And it really is about – we call it losing guest counts. It's not losing customers; it's losing customer visits. So it's customers that may not be visiting us as often as they were historically. And if we can regain some of those additional visits, especially at breakfast time, which is, as you know, a very habitual ritual. And so, if we can get those customers coming again at breakfast time, it would be a huge benefit.

Stephen J. Easterbrook

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

A

Just to support Kevin's comments, particularly around, if you like, the technology ecosystem we're building here. For us to have a personalized relationship with our customers, which I think will be valuable to us and also make it valuable to them, we've got to find ways for them to identify themselves when they enter the drive-thru, without slowing the drive-thru process down. Identify themselves at the self-order kiosk, again, even though there's less pressure on time there, you don't want it to slow them down.

Or for example, if they're having home delivery and when we get to route delivery through the McDonald's app and we're working with our partner of Uber Eats, we're going to be getting the ability to route those orders through the McDonald's app. Once we can start to link drive-thru transactions to in-store transactions to home delivery, we start to build a really good picture of our customers individually, person-by-person. I think that will be incredibly valuable for us to make ourselves more relevant and more interesting to those customers. And from a customer perspective, just make the experience smoother and more enjoyable.

So you can expect to hear more. There are certainly some initiatives we're working on in the markets right now on those. Nothing to say at scale yet. But I can assure you the culture of innovation that we've got going here is playing out. We've got a number of initiatives in a number of our markets where we're learning very, very quickly how best to identify customers – or for customers to choose to identify themselves is a better way of saying it – at

the drive-thru, at the in-store. We believe we've got the home delivery piece already initiated. And we're excited about what that could offer the business.

Mike Cieplak

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

A

Our next question is from Jon Tower with Wells Fargo.

Jon Tower

Analyst, Wells Fargo Securities LLC

Q

Great. Thanks. I just wanted to talk quickly on the unit growth. I think today, you bumped up your expectations for 2019 to 800 stores net. And over the past two years, you've seen a nice jump in absolute net numbers. So can you discuss whether or not you expect this type of net openings to persist in the future? What's fueling this growth? Are franchisees in new markets seeing better returns than in the past? Thank you.

Kevin M. Ozan

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

A

Yeah, thanks, Jon, for the question. Couple things. First, related to the, I'll call it, change, slight change, in guidance in the outlook section of the release, really what's driving that net additions number of about 50 higher than it was last quarter is less closings.

So our gross openings number for this year will be similar to what we thought it was going to be, but the closings that we originally anticipated at the beginning of the year are a little bit lower. And about half of those are in our Developmental Licensed markets and about half of them are in the International Operated Markets. Half of the change in closings, that is.

As far as how we think about unit growth, there's still a lot of potential, even in our mature markets. So markets like Canada, France, Italy, Spain, have a lot of opportunity to continue growing new units. And the U.S. even long-term, we believe.

Now what's helpful in the way we've changed our business model is what you actually see is right now, substantially, the large portion of openings are in our Developmental Licensed Markets, China and the other DL markets, which use their capital. So it's a pretty efficient way for us to grow. So you should expect to see continued growth in new units. Again, both in the DL markets by our partners, as well as in our more mature markets that we own, like the ones I spoke about.

Stephen J. Easterbrook

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

A

Just to add onto that, I just want to give a shout-out to some of the mid-size operated markets. Recently, I've been in Italy, Poland, Netherlands. These markets are doing double-digit sales comps on top of double-digit sales comps. And hence, that's creating clearly significant increase in volumes and throughput in the restaurants and it's putting some capacity pressure on.

So I can tell you the desire in the markets is to start to pick up the openings a little bit. I'm heading out to Russia here in about two months' time to spend some time there with the team. And again, with the strong growth in both guest counts and sales they're seeing, I know they have an ambition for growth.

And if you remember, we previously called that segment the High Growth segment. And that was because we expected them to grow units at a greater pace than perhaps the more mature markets.

So we're keeping a real close eye on it. And the stronger we grow the business, then the stronger the confidence level is to grow the units, as well, so more to come by the end of the year.

Mike Cieplak

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

A

Our next question is from Brian Bittner with Oppenheimer.

Brian Bittner

Analyst, Oppenheimer & Co., Inc.

Q

Hi. Thanks for the question. Can you guys talk a little bit more about your store-level margins in the United States? It's the first time they've expanded in five quarters and, certainly, were a much healthier level than all of us analysts were forecasting.

I know you said refranchising was a positive impact, Kevin, but I think probably a similar impact as you've seen in recent quarters. So are the franchisees seeing a similar margin trend change this quarter? And, if so, what drove that? And then just following up on the EOTF, can you tell us what the net impact you believe EOTF was on comps this quarter? And how you expect that to change into the second half? Thanks.

Kevin M. Ozan

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

A

Yeah, thanks, Brian. Let me start with the store-level margins. And I guess I'll talk about company-operated margins, because, obviously, those are our restaurants, so I can see a lot of detail related to those.

I think one of the big differences is, certainly comps in the second quarter were higher than they were, let's say, in the first quarter. And obviously, higher comps definitely helped that. But the other thing I'd say is there's a little bit more stability in the restaurants in 2019 than 2018.

Steve talked earlier about the hard work and all these things that we threw at the restaurant in 2018, including EOTF, a lot of projects, fresh beef, the restructure we did in the field, all those changes that impacted the restaurants.

And so as we've now, I'll say, stabilized the business a little bit, and just have less overall initiative deployment, as well as slowing the pace or getting near the end of kind of our refranchising, the restaurants are now able to just focus on running the restaurants as efficiently as possible.

And so we saw kind of more efficiency, labor productivity in the second quarter than we saw in the first quarter and last year. On the franchisee side, we've talked about their cash flow is up, so their unit level economics have been doing well, similarly. So I think that's probably the biggest change as far as what we're seeing in margins versus last year, certainly.

Related to EOTF, I'd say the benefit in the second quarter was a little higher than it was in the first quarter. And we would expect that to be relatively similar for the remaining quarters of this year. As we said, we completed about 1,000 projects so far this year, of our 2,000 that we'll complete in total. But that's coming off of finishing about 4,500 last year. So we have a big base of projects that are now complete that we're seeing the benefit of in

addition to kind of improvement in how we're doing those projects; as Steve talked about, less downtime, quicker recovery, et cetera. So we expect those EOTF benefits to continue. And, obviously, as we have completed more projects, that certainly helps future results.

Mike Cieplak

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

A

As we near the top of the hour, we'll take one final question from Sara Senatore with Bernstein.

Sara Harkavy Senatore

Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you very much. I just have two quick follow-ups, if I may. The first was on the EOTF and traffic in the U.S. I had been under the impression that last year, part of the issue was during the store closures, you lost some traffic. And I would've thought maybe you would've gotten that back this year, but it sounds sort of like you haven't gotten the traffic back so much as the customers that are still going to McDonald's are just spending more and EOTF is supporting that. But I just want to understand the dynamic there between in lapping the closures.

And then just on China, are you seeing any cannibalization? We've noticed across board, a lot of restaurants taking up unit growth in China and seeing their comps decelerate accordingly. Is that something that you have to contemplate or are you still so under-penetrated, it's not really an issue there?

Kevin M. Ozan

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

A

I can start with the EOTF. Related to EOTF, so last year, as you mentioned, we had restaurants closed, the ones that needed to be, primarily the ones that had the big projects, the, what we call, non-modernized, so the ones where we needed to do a remodel plus the EOTF components. This year, while there's less number of projects being done, there are a higher percentage of those non-mods being done.

And so while we've gotten better at reducing the amount of time that they're closed, we still have some of those closures. Now that isn't the only issue, obviously, related to traffic, though. Again, to be fair, we were losing traffic before we started the EOTF, and that won't fix all the issues related to traffic. So the traffic piece is beyond just EOTF. And as we've gotten better and done more of these EOTF projects, we're getting better at completing those, but that, in and of itself, won't resolve all of the traffic issues.

Stephen J. Easterbrook

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

A

Just to pick up on the China question, Sara. We had really strong system-wide sales growth in China for the quarter. Clearly, we've got a rapid pace of expansion of new restaurant openings, but we also grew sales and grew guest count in the quarter as well. So the core business is robust and I would say probably exceeding the opening plans that we had initially expected. I mean, if you look at the five-year period ending 2022, our partners are looking to exceed more than 2,000 openings. They're certainly on track for that at the moment. And having caught up with them recently, they're in very confident mood about the state of the business. I mean, it's incredibly competitive. You've seen the pace at which other people are expanding, but it is a huge market.

The emerging middle class, the greater affordability of the mass population there is heading towards western QSR-type of average checks and affordability. So it's certainly a market we're excited about. We're very confident about the long-term future there and really pleased with the way the partners are working out as well. They're

doing a terrific job. So it'll be more than 400 openings this year after about 400-plus last year as well. And if they can keep the sales comps going at the same time, then, clearly, that indicates a healthy position for the business.

Mike Cieplak

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

Okay. Thanks, everyone, for joining us. Have a good day.

Operator: This concludes McDonald's Corporation investor conference call.

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