

28-Jul-2020

McDonald's Corp. (MCD)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello, and welcome to McDonald's Second 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 question 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 will turn it over to Chris.

Chris Kempczinski

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

Thank you, and good morning. As I reflect back to our first quarter earnings call a short 90 days ago, I talked about uncertainty in the world amidst the COVID pandemic and our methodical approach to reopening, grounded in what's best for the safety of our customers and crew.

During the second quarter, the dedication of the McDonald's System was on display as we worked together to safely reopen nearly all of the McDonald's restaurants that had temporarily closed in late March, leading to continued improvement in our sales results. As of today, nearly all our restaurants globally are open for business, almost all markets are operating with drive-thru and delivery, and many markets have also begun to reopen dining rooms.

I want to say a huge thank you to franchisees, crew members, suppliers and company employees. Without their continued hard work and dedication, this would not have been possible.

We have said that since the start of the pandemic, that we entered from a position of strength. Over the last several years, our Velocity Growth Plan drove broad-based strength in markets around the world. More importantly, however, we believe McDonald's possesses several unique advantages that ensure our success is built to last. These advantages have been evident throughout the crisis.

First is our iconic brand. McDonald's is one of the world's leading brands. And the trust customers have in McDonald's has proven to be a significant advantage during these uncertain times. Customers have been seeking known and familiar brands they can count on. And for our customers, while safety is a top concern, the need for value and convenience is also on the rise, playing to McDonald's' historic strengths.

Second, McDonald's is an execution machine. We know how to run great restaurants. And that operating prowess has been put to the ultimate test during the pandemic. Within a matter of weeks, the McDonald's System made operational modifications across 30,000 restaurants, while closing and then reopening another 9,000 restaurants. We introduced new safety procedures in all our restaurants, modified our menus, and developed new contactless ways to serve our customers.

Amidst all these changes, customer satisfaction actually improved across almost every major market and the US has hit new all-time highs for customer satisfaction. Drive-thru times have also improved across most major markets, averaging 15 to 20 seconds of improvement.

And speaking of drive-thrus, our unmatched drive-thru penetration has allowed us to continue serving more customers and more markets than anyone else. Across our big five IOM markets, Australia, Canada, France, Germany and the UK, about 70% of our restaurants offer drive-thru, and this safe and convenient service channel has been particularly appealing to our customers during the pandemic. We've seen significant increases in drive-thru sales in these markets during COVID.

Finally, the strength of our system, our franchisees, employees and suppliers, has been, and always will be, our secret sauce. Our three-legged stool is committed to feeding and fostering the nearly 40,000 communities where we operate, and the pandemic has demonstrated our system's unwavering commitment.

There have been countless examples of our system going above and beyond to be there for those communities who needed us most. From healthcare workers to truck drivers, to people working three shifts to make masks and respirators, we stayed open so they could keep going.

Every franchisee comes from and is rooted in the local community. They take responsibility for building the local community, which is why our brand is strongest at the local level. Thanks to market and franchisee leadership, we were able to identify opportunities to be good neighbors in ways that are the most meaningful to customers. And this has been especially important the last few months.

Our suppliers ensured that we had no breaks in supply for food, packaging, material, toys, equipment or other strategic categories globally. This is an incredible feat, given some of the significant challenges experienced in the past few months and a testament to our strong supply chain teams, both globally and locally, and the partnership that they have with our suppliers. At the same time, in just a matter of weeks, our teams built a global supply chain for PPE virtually from scratch.

Turning to our Q2 operating results, I'll provide a few headlines and observations, and then Kevin will provide more details, including key financials.

In the US, virtually all restaurants remained open and we saw results improve sequentially through the quarter. To ensure we kept our crew and customers safe while remaining open, we've changed nearly 50 operating procedures in accordance with guidance from state and local health experts.

In Q2, we also ran a highly successful Thank You Meal program to recognize the extraordinary dedication and selflessness of first responders.

In our International Operated Market segment, when we last spoke, about 45% of our restaurants were open in some manner. Several of our largest markets, including the UK, Spain, France, and Italy, were completely closed for prolonged periods during the quarter. With a methodical approach, however, our teams have reopened restaurants across this segment and nearly all restaurants are now open to serve customers. We've seen strong pent-up customer demand, which is driving encouraging sequential sales improvement.

Finally, our International Developmental Licensed segment experienced several challenges throughout the quarter. Our Latin America business was severely pressured due to the high incidence of coronavirus in several countries and its less developed drive-thru penetration. In China, after early signs suggesting a solid recovery, our pace of improvement has slowed as customers remain wary of social activities. And we now expect this more subdued pattern to continue into 2021.

Worth noting that Japan had positive comp sales for the quarter, partly thanks to our brand's reputation for cleanliness and convenience with Japanese customers.

As you can see, it remains a dynamic situation as the threat of COVID-19 continues to depress consumer sentiment and the vagaries of the pandemic create an unpredictable operating environment. In many markets around the world, most of notably in the US, the public health situation appears to be worsening. Nonetheless, I believe that Q2 represents the trough in our performance, as McDonald's has learned to adjust our operations to this new environment.

Regardless of the overall level of industry growth, I believe our markets and franchisees are well positioned to grow market share going forward. Three factors give me confidence. First, the financial health of our system's strong. As you know, we moved quickly to defer rent and royalties for franchisees, injecting nearly \$1 billion of liquidity into our system at the outset of the pandemic. When necessary, we're providing timely, targeted and temporary assistance to franchisees needing additional support.

Government programs, such as the PPP program in the US and the Chancellor's program in the UK, also provided strong financial relief to our franchisees. And the menu and operational modifications we introduced have further supported franchisee P&Ls. Collectively, these actions have significantly reduced the adverse cash flow impact of COVID-19 on the average McDonald's restaurant.

Second, we have amassed a sizable marketing war chest to invest in the back half of 2020. During Q2, most major markets significantly reduced their marketing spend and value activities. As an example, in the US, marketing spend was down 70% as we chose to conserve our resources until the situation stabilized. These funds will now be reinvested in Q3 and Q4.

Additionally, as we previously announced, McDonald's will also invest an incremental \$200 million in marketing spend across our US and International Operated Markets in the second half to accelerate recovery, roughly equivalent to one additional month of media in every owned market. Together, these actions will result in a sizable increase in our marketing spend for the balance of the year.

And third, our laser-like focus on what we call the 3Ds: drive-thru, delivery, and digital. Thanks to our strategic foresight, McDonald's is well developed in each of these channels and we see opportunities to extend our 3D advantage. You'll hear more about the 3Ds in our strategic plans later in the year.

Again, I want to thank our system for the extraordinary dedication and resilience they demonstrated in Q2. And to our customers, I want to thank you for your trust in McDonald's. We're ready to serve.

I'll now turn it over to Kevin to talk in more detail about our second quarter results.

Kevin M. Ozan

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

Thanks, Chris. I'll start by walking through our comp performance for the quarter and an early read on July, move on to some items on the P&L, and then end with an update on our financial position.

While this quarter was not without its challenges, we're encouraged by our global comp sales improvement throughout the quarter and into July. Comps improved sequentially throughout Q2, as markets reopened and restrictions were eased. Global comp sales were down 24% for the quarter and improved as we progressed through the quarter, with the month of June down 12%.

We entered the quarter with about 75% of our restaurants open. And, as Chris noted, today, nearly all have reopened to serve customers. While in June we recovered nearly 90% of our 2019 sales, performance across the markets is varied and uneven, depending on external factors such as government restrictions and consumer sentiment, given concerns of resurgence. For as long as the virus is present, this is the likely operating environment, especially as we also consider government assistance to consumers rolling off in many markets and general economic uncertainty. And we believe we're well positioned to navigate through it all.

That said, some consistent themes have emerged. Comp sales continue to be heavily reliant on check growth from larger orders, with guest counts negative. The number of drive-thrus impacts a market's pace of recovery. As Chris mentioned, our drive-thrus overall have proven to be a competitive advantage for us. And markets with a higher percentage of drive-thrus are showing quicker recovery.

Markets with a higher concentration of city center and mall restaurants are seeing heavier impacts from reduced foot traffic. And travel or tourist dependent locations are slower to recover as mobility remains suppressed.

In looking at performance across the segments, the International Operated Market segment experienced a sharp decline, with more than half of the restaurants temporarily closed early in the quarter. Comp sales were down 41% for the quarter, improving to down 18% for the month of June, as key markets like France began reopening in May and the UK began reopening in June.

Australia delivered positive comp sales for both May and June, bolstered by strong drive-thru and delivery performance. Australia has doubled its delivery sales mix to nearly 10% of sales, a trend we're seeing across several of our international markets.

While we've seen a significant uptick in drive-thru as a percentage of total sales throughout the segment, a crucial step in our recovery is the reopening of dining rooms. Pre-COVID, nearly 70% of customer orders were in-restaurant across our larger markets, so closing the dining area or even limiting dine-in capacity has a substantial impact on results.

Today, almost all restaurants and about two-thirds of the dining rooms have reopened in the segment, although many restaurants are still operating with restrictions, such as limited hours or channels based on local regulations.

In July, comp sales in the IOM segment have continued to improve, although they remain negative in the high single digits.

Turning to the US, comp sales for the quarter were down 8.7% and improved as we progressed through the quarter, with June down 2.3%. Breakfast continues to be disproportionately impacted by disruptions to commuting routines. And while weekend recovery is still lagging weekday recovery, the gap is narrowing.

Throughout the pandemic, we've benefited greatly from nearly all of our restaurants remaining open to serve customers, particularly with drive-thrus in nearly 95% of our locations. As customers shifted to a more contactless experience, drive-thru accounted for nearly 90% of our sales again this quarter. We also continue to see an uptick in delivery and digital transactions per restaurant.

Mid-quarter, we began to reopen dining rooms in the US with reduced seating capacity for customers who want to enjoy their food on premise. In early July, we paused as we've seen resurgences across the country. And today, we have about 2,000 dining rooms open. Together with our franchisees, we're taking a thoughtful and responsible approach to determine the right time to reopen the remaining dining rooms.

The US has continued to see improving comp sales through July, with comps turning slightly positive during the month.

Comp sales in the International Developmental Licensed segment were down 24% for the quarter, with the months of May and June both down about 20%. As Chris mentioned, Latin America was the hardest hit geography across the segment, while Japan delivered positive comp sales for the quarter. And in China, recovery has been somewhat uneven, as consumers remain cautious on resuming pre-COVID routines, especially in light of resurgence concerns. Increased competitive activity and the fact that schools have been closed also are impacting the pace of recovery.

In terms of new unit development, China has opened about 150 restaurants through June. We remain confident in new restaurant growth opportunities in China, with a plan to open about 400 new restaurants this year.

While we expect recovery to continue to be somewhat gradual and uneven for many markets around the globe in the near-term, we're proud of our teams and the way we've responded to the pandemic.

Moving to 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 efficiently convert top line growth to the bottom line. Despite the challenging environment, McDonald's restaurants generated over \$19 billion in system-wide sales for the quarter. Franchise margins represented about 90% of overall margin dollars and were a key component of operating income.

There are a couple P&L lines specifically impacted by COVID-19-related items. First, G&A increased \$114 million, or 22% in constant currencies, for the quarter. As Chris mentioned, the company is making an incremental marketing contribution to the US and IOM markets. The amount related to that contribution included in G&A for Q2 was about \$160 million, which more than offset lower travel costs and lower incentive compensation accruals.

Turning to the other operating income and expense section, gains on restaurant sales for the full year are still expected to be down significantly versus last year, as we anticipate a minimal amount of restaurant sale activity for the remainder of the year. Our equity and earnings of affiliates for the full year is projected to be down substantially.

We recorded an additional \$45 million for reserves for bad debts related to rent and royalty deferrals for Q2. And finally, in further supporting our franchisees, we made one-time payments of about \$30 million to distribution centers for obsolete inventory. This was a result of the abrupt reduction in consumer demand and product mix shifts early in the pandemic.

As I've mentioned before, the financial health of our system was an underlying strength of our business coming into the pandemic, and we've taken actions to preserve financial flexibility. As a reminder, we suspended our share repurchase program in early March.

We also bolstered our financial position by securing \$6.5 billion of new financing back in Q1. This enabled us to invest in the system in several ways. We provided nearly \$1 billion of broad-based financial liquidity assistance to our franchisees, primarily in the form of rent and royalty deferrals. As a result, free cash flow was negative in the second quarter and positive for the first half of the year.

Based on our current operating performance and our anticipated collection of a majority of the deferrals in Q3 and Q4, we still expect free cash flow to be positive for the remainder of the year.

Further building on the broad-based liquidity support, we're also assessing the financial health of specific at-risk franchisee and Developmental Licensee organizations. We're using an objective framework for decision-making. And we expect that only a small percent of organizations will require further assistance.

The financial health and strength of our franchisees has been a competitive advantage for McDonald's for years, and we expect that to continue.

Finally, as we've mentioned, we invested in incremental marketing across the US and IOM markets to further accelerate recovery and drive growth.

In terms of capital expenditures, we took a very practical approach to development activity during the onset of the pandemic by pausing most project work. As many franchisees are willing and able to invest and some work has resumed, our expected capital spend for 2020 is now about \$1.6 billion versus the original \$2.4 billion. About half of the \$1.6 billion will be dedicated to the US business, including completing roughly 900 EOTF projects. Additionally, we now plan to open about 950 gross and 350 net new restaurants this year.

The US is accelerating some restaurant closings previously planned for future years. Of the 200 US closures for this year, over half are low-volume restaurants in Walmart store locations.

Consistent with enhancing financial flexibility and our franchising strategy, we're planning to divest a portion of our stake in McDonald's Japan. As a result of the strong performance of the McDonald's Japan business over the past few years and our confidence in the local management team, we believe it's the right time to gradually reduce our ownership stake in the market. This will take some time because of the low trading volume of McDonald's Japan shares. As a reminder, we currently own about 49% of the business and we will retain at least 35% ownership. This decision provides us with additional financial flexibility to execute our capital allocation strategy, while also demonstrating our commitment to our Japanese business.

Regarding uses of cash, our top priorities remain the same: first, investing in the business for growth; and second, prioritizing dividends to our shareholders. After that, we'll look to reduce debt in the near-term to lower our elevated leverage ratios. 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, our franchisees remain financially strong, and our shareholders are duly rewarded.

Now, I'll turn it back to Chris.

Chris Kempczinski

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

Thanks, Kevin. Here at McDonald's, we remain well positioned to operate through this crisis from a position of competitive strength and we're confident in our ability to grow market share as we look ahead.

Tomorrow, we're holding our first-ever digital convening of operators, suppliers, and employees worldwide. We're calling it our Worldwide Connection. We'll use this touch point to reflect on the inherent strengths of our system by highlighting the enduring values that will continue to guide us as we move forward. Just as we've done since the very beginning, we'll draw on our solid foundation, unique advantages, and core equities to meet the needs of today, while building towards a better tomorrow.

Our customer focus and current prioritization of resources will be important levers as we drive our recovery. And we will continue to use our strategic agility to adapt to the evolving environment. While the Velocity Growth Plan has served us well and elements of the plan will continue to be important, we will continue to evolve the strategy as needed to meet the needs of the customer.

We look forward to sharing updates later in the year.

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.

Our first question is from Andrew Charles with Cowen.

A

Andrew Charles

Analyst, Cowen and Company

Great, thanks. Breakfast has been a bit of a sore spot for the US business over the last several years, despite efforts in place to help improve performance focused on value, advertising, and innovation. So can you talk a little about why efforts to reinvigorate breakfast will be different under Joe [Erlinger] during a time when morning routines are seeing pronounced disruption?

Q

And if I can just clarify one thing. Were July US comps slightly positive for the month, or did they trend slightly positive at some point during the month? Thanks.

Chris Kempczinski

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

A

Good morning, Andrew. Thank you for the question. And on the breakfast point, certainly, as we've talked about on prior calls, breakfast has been one of the more challenged dayparts due to coronavirus. You mentioned and you alluded to the fact that we have had challenges in breakfast over a longer period of time.

I think there's been a couple areas there that have driven that. Certainly, one has been the much more increased level of competitive activity that we've seen in breakfast. Breakfast, as you know, prior to the pandemic, was the only daypart that was growing. And so, as a result, there were a lot of new competitors that were flooding into the breakfast daypart. That certainly was one area of pressure for us.

And then, I would also just honestly say some of it was around focus. And we were not as focused as we were rolling out other things like hot off the grill. The other dayparts for us took on more time and energy and investment. And so, as we emerge out of this, I think part of it is certainly going to be a rededication from a marketing and investment standpoint to go after breakfast. I think our ability through the drive-thrus right now to be fast at breakfast is certainly an advantage that we're looking for going forward.

And then, we will have innovation in breakfast as well. If you look at how we've performed through the pandemic, even though breakfast is certainly in the US still the most challenged daypart, we're actually growing our breakfast share. And so, while it is a drag from an overall standpoint, we're gaining share at breakfast. And I know the US operators and Joe are hopeful to continue that trend.

As to the point about July, let me pass it over to Kevin to give you the specifics.

Kevin M. Ozan

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

A

Yeah, Andrew, related to July US comps, I'd say they trended up a little bit throughout the month, but they've been running slightly positive for most of the month. And, obviously, with a few days left, we expect it to be slightly positive for the full month also.

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. I was wondering, Kevin, if you could give us a sense of what the comps in the units in IOM are running, when you exclude all the impact from the closures. And I guess a second and related question would be what do you think the biggest impediments in those markets are in terms of getting back to positive? Is it a matter of [ph] getting the dining rooms open, (28:25) or do you think something else will be needed to see a positive number?

Kevin M. Ozan

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

A

Yeah, thanks, David. All right. A couple things. Let's talk about July. I'll talk about July primarily, since it's our most recent information.

We talked about Australia being positive. And I'll give a quick round of the big five markets, if you will. Australia, we talked about being positive in May and June. They continue to be positive in July. Now, remember, Australia

was one of the few markets around the world, in addition to Canada and US, that remained open through all this, so they've got a little different profile certainly than the European markets.

Canada, I'd say is relatively similar to how the US is behaving, meaning that they are just turning slightly positive in July. And, again, remember they remained open, so I'd use the US kind of profile as a proxy for Canada.

Europe, then, is obviously a little different, France, Germany, and UK. France and the UK were completely closed, remember, so they're a little slower to return. I mentioned that France began reopening in May. UK began reopening in June. UK is just beginning to reopen dining rooms. So you've got those different dynamics going on in the European markets.

If I look at those three markets in total, they're roughly, I'll call them, negative high single digits to low double digits. So that overall, when you look at those five markets in July, we're running probably high – I'm sorry, mid-negative single digits for that group of five in July.

As far as the factors that are impacting those, a couple things. I think one is the fact that several of those markets, as I mentioned, were fully closed, so it just – while there's an immediate rush back and we all see the lines in the drive-thru, et cetera, the reality is after a week or of a couple weeks of things settle down, it does take a little bit of time to kind of build up and get back to more closer to normal, I'll say.

Dining rooms is a big thing, as I mentioned in my script. Going into COVID, about 70% of our orders were in restaurant. And so, I think in order to fully get certainly guest counts back, it'll be getting the dining rooms open in all of those markets.

And then, the other thing that goes on in some of those European markets is specific locations, whether that's travel centers or tourist locations, some countries, certainly the France's, Spain's, Italy's, are more dependent on tourism. And so, you see some of those markets being impacted more than others.

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. My question is about unit growth. And I think there was a time, maybe not long ago, pre-COVID, that there was a thought at McDonald's that this is maybe an opportunity to start to accelerate unit growth, particularly in some of those international markets. Do you think that opportunity has changed? Has it gotten better? When you talk about reducing unit growth this year, what's the primary factor? Is it franchisee lack of willingness because there's a distraction, or is it just the construction? How do we think about unit growth going forward? What are the causes for the delay? And is this even a bigger opportunity, as many other restaurants have talked about, in terms of an opportunity to gain share and getting better real estate as a result of COVID?

Kevin M. Ozan

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

A

Yeah, thanks, John. So yeah, first, let me talk about this year which, to your point, I think this year, what we are seeing is there was certainly immediate or near-term disruption, both with our franchisees and in the construction industry, in a lot of those markets. And so that's why you're seeing, why we're seeing, I'll say, reduced openings

this year. That doesn't change our belief in the opportunity going forward, especially I'd say in Europe, where I think there may be some independent restaurant units that are having some bigger challenges, which may present some further opportunities for us.

So our expectation is that beginning next year, we go back to kind of where we thought we would have been for unit growth in 2021. And, again, especially in Europe, we believe there's a lot of opportunity for growth.

I mentioned in our script that China's continuing to grow, so we think that they'll still open about 400 units this year. But Europe, which we have slowed down a little bit this year because of the near-term disruption, our expectation right now – and, obviously, that's all dependent on what happens with the pandemic going forward, but right now, our expectation is to get back to having significant unit growth in Europe. We do think there's a lot of opportunities in our key markets in Europe.

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

Thanks for taking the question. I'm just curious. I think, Chris, you had mentioned earlier that in the US, obviously, you've made some fairly significant operational procedure changes. And, in particular, I believe you pulled some menu items off, including All Day Breakfast. So can you discuss what you think will remain as permanent changes versus what are temporary, tied to the pandemic right now?

Chris Kempczinski

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

A

Sure. Thanks, Jon. So if you look at the menu, you're right. We went to limited menu. It was largely our core menu in the US and a number of other major markets around the world. It had a number of benefits to us. It certainly made the restaurants easier to operate, particularly as we had some challenges with just staffing levels due to coronavirus.

It also had a very positive benefit around productivity and margins. All of that was also very helpful as we navigated through the second quarter.

As we come out of it, as I've said in prior times, I think it is a safe bet that you are going to see us add items back to the menu. I think it's also equally a safe bet that we're not going to go all the way back to where we were. And so, how that evolution looks is going to vary market-to-market.

In the US, I do know that there is innovation that is planned for later this year that's going to bring some menu items on. And then, what the US operators have talked about with our team has been let's just make sure every item that we add earns its way back onto the menu. And I think that mentality, that mindset, is how, not just the US but every market is sort of looking at it.

Mike Cieplak

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

A

Our next question is from David Palmer with Evercore.

David Palmer

Analyst, Evercore ISI



Thanks. In your International Operated Markets and the big three in Europe, in particular, could you talk to the sales trends by format, meaning units with drive-thru versus walk-in only units?

And relatedly, I don't know if you're able to see the informal eating out market trend lately and know how you're maybe doing in terms of market share trends. I'm very curious to know if the pain is really great out there from a competitive set that is walk-in only and that could be sort of making the bed for you in a positive way as things get back to dining rooms being open. Thanks.

Chris Kempczinski

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



Hi, David. It's Chris. I'll take the first part of that, and then if Kevin has anything else to add, I'll pass it off to him.

But I think overall, what you're talking about is accurate or certainly something that is worth paying attention to in Europe, which is in Europe, we do face a different competitive set. It tends to be, in many cases, smaller operators, bakeries, kind of places that are much more dependent on the walk-in business. Those competitors, in countries like France and Germany, are certainly under quite a bit of pressure. And we're seeing that right now from a variety of different media that we're hearing about, some of the difficulty that exists in those markets. That does create for us an opportunity to take share because of our drive-thru business.

I won't get into sort of the by format details, but I would just say in general, and Kevin laid it out in his opening remarks, when we have a drive-thru business, you do tend to see those businesses come back faster. Consumers are more in the habit of going to that restaurant and then they see the dining room's open and that leads to a faster recovery on the dining room business.

But now, with basically almost all of our dining rooms open in Europe, even if you didn't have a drive-thru, we're seeing a nice recovery there. It's just not as fast as if you had a drive-thru that was allowing you to operate as well.

And, Kevin, I'll pass it off to you for anything else you want to add on that.

Kevin M. Ozan

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



Yeah, just to give a little detail on what Chris was just saying, just to give some numbers. If I look at those big three in Europe that you mentioned, France, Germany, UK, roughly two-thirds of the restaurants in those markets have a drive-thru. And if we think about pre-COVID, about a third of our sales in those markets were through the drive-thru pre-COVID. Now, about two-thirds of our sales are through the drive-thru.

So we've certainly seen the advantage of having drive-thrus in those markets. And, as Chris mentioned, those do tend to come back quicker than the restaurants without drive-thru.

Mike Cieplak

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



Our next question is from Sara Senatore with Bernstein.

Sara Harkavy Senatore

Analyst, Sanford C Bernstein & Co., LLC



Thank you. I wanted to ask about China. And I know it's not, at this point, a huge contributor to EBIT, but just as a read for other markets, you said that you are seeing kind of a retrenchment as customers remain wary and you'll expect to see that into 2021.

I guess as you think about the risk of more resurge in COVID in other markets, is that primarily the implication or is there some function of China – we've heard there are maybe more lockdowns in some of the cities than what we've seen in other countries. Just trying to understand kind of if you'd expect to see a similar retrenchment in other markets.

And I guess related to that in the US, if you could just talk about the difference in dayparts or what you're seeing between weekends and weekdays, if there are any kind of different behavior patterns that you can tell us about that. I'm just trying to sort of get a sense of how to think about recovery from here, depending on the different scenarios that might occur.

Chris Kempczinski

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



Sure. Thanks, Sara. I do think China's probably more unique and, therefore, probably not a good proxy to think about for the other markets. Start with the fact that in China, only about 15% of the restaurants there have drive-thru. And so, for all the reasons that we've already been talking about, it's a different dynamic and a more challenging dynamic when you don't have a drive-thru business. So I think that's one big difference.

I think also you mentioned, you touched on there has been kind of a variety of different government actions and I'd say sort of several different waves of the coronavirus. All of that, when you take it in combination with the fact that there have been other epidemics in China, I think all of that is weighing on the minds of the Chinese consumer and definitely making them more wary.

What you're seeing in China is you're seeing many of the kind of non-Western restaurants go to very aggressive value programs right now, trying to stimulate some demand in the market. And we do think that that market is going to be more promotional, certainly through the balance of this year, again, as competitors are all trying to get some traffic stimulated there and encourage people to come out of the house.

So long-winded way of saying I think China, there's a number of factors that are going on in China that don't allow it to really be a good read-through to other markets.

As to the US and the difference between weekdays and weekends, certainly, earlier in the pandemic, we were seeing a bigger hit on weekends. As we've now moved through that and getting to, I guess I'd say more of a steady state in terms of where we're at, that disparity between the weekend and weekdays is evening out and it's not as pronounced as it was earlier.

Weekend still does provide a tougher comp, a tougher lap than the weekday, but again, the disparity that we saw between weekend and weekdays is leveling out.

Kevin M. Ozan

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



And then I'll just add daypart, that you mentioned. I think, as Chris mentioned earlier, breakfast is the biggest drag, if you will, in comp, but we're gaining share at breakfast. It's just that the overall breakfast market is declining. And that'd be for June and into July, I'd say, for the US, that is.

Dinner, both in June and July, is contributing to comps. So it's been positive. And then, I'd say lunch is in between the two.

Mike Cieplak

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

A

Our next question is from Andrew Strelzik with BMO.

Andrew Strelzik

Analyst, BMO Capital Markets Corp.

Q

Hey, good morning. Thanks for taking the question. You talked a bit about the marketing war chest in the back half of the year. I'm just wondering what role innovation will play. I know there was a bit of a pause due to the pandemic. Has that started to crank back up a little bit, and should we expect to see anything through the balance of the year?

Chris Kempczinski

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

A

There will be some innovation. I would say that the bulk of that spend is not intended to be going toward innovation. The bulk of that spend is intended for really core menu items and perhaps spotlighting some of our service channel opportunities like, for example, digital.

But, as I said earlier when I talked about menu, we are going to have some menu innovation in the US in the back half of the year. So it may get some, but I wouldn't think about that war chest as being deployed largely against innovation. It is going to be largely against the base business, because our view is, right now, consumers are still looking for sort of the trusted favorites, which is why core menu makes sense for us.

Mike Cieplak

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

A

Our next question is from Chris O'Cull with Stifel.

Chris O'Cull

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thanks. Good morning. I was hoping you could frame the increase you're seeing in the check in the US. And have you seen any sequential change in the check as you moved through the quarter or as mobility increases in certain markets?

Chris Kempczinski

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

A

Yeah, thanks, Chris. So the check, I think industry-wide, there were some big check numbers out there. Part of it was due to mix, so you saw delivery becoming a much more pronounced part of the mix during Q2. Also, I think what we were seeing is just larger order sizes, kind of this dynamic of we'll send someone out to order on behalf of the whole family. And so all of that, we're seeing average checks going up, call it, I don't know, 30% increase in average check in the US.

And in terms of what that looks like going forward, we are starting to see it rebalance to what you would imagine are more normal or sustaining levels, meaning the traffic is improving. As traffic is improving, you're seeing check come down in terms of its contribution to growth. But still, we are in a negative traffic environment and it is being driven largely by check, but just the trajectory of it is starting to look a little bit more as you would expect.

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 a question on the likelihood of a recession coming forward ahead of – or once we look past COVID. Just wondering if you can give your thoughts on a potential US recession versus 12 years ago or perhaps you're seeing certain international markets where you're seeing some outsized consumer weakness. Just wondering how the McDonald's brand has changed over that time for the better to help insulate or whether your strategy might change willingness to push more value or otherwise. Just trying to get a sense for the outlook if there's any market that you see recessionary concerns on horizon. Thank you.

Chris Kempczinski

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

A

Sure. Well, one of the things that we do is we do every week a tracking survey of consumers across most of our major markets. And I would say one of the things that we have – that definitely pops in that is concern the anxiety that exists out there around the economy and consumers' belief that we are in a sort of recessionary type of dynamic.

It's been interesting. In many cases, and I think in even our most recent poll that we did, you see economic concerns eclipse public health or public safety concerns. And so, as I look at all that, I'm certainly not qualified to make any predictions around whether we're going to be in recession or not, but I'd certainly say there's a lot of warning signs out there that would suggest that the consumer sentiment and consumer concern about the economy is negative and going in the wrong direction.

As we think about what that means for our business, and Kevin can talk more about this, but our business tends to be pretty resilient, whether it's through recessionary times or through times of growth. And so, we feel well positioned during those types of periods. But I think you're touching on something that's important, which is as you go into potentially a more recessionary type of environment in a number of major markets, having good affordability and making sure that that is a key component of your marketing mix is really important.

And that's a conversation that I know our leadership teams in markets around the world, including the US, are having with our franchisees right now.

One of the things that we need to make sure is that coming out of Q2, and I think maybe some of just the shock that sort of went through the system as the pandemic spread, we ended up, as I talked about, in terms of our reduction of marketing support, we went into more of a defensive posture. Now, as we kind of go into a more normal, or what we're kind of saying new normal, next normal, whatever the phrase you want to use, operating environment, it's time for us to get back on the front foot. That's why we have the marketing war chest, but it also

means we are going to need to be thinking about how affordability and value can play for all the reasons you were mentioning in your question.

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 very much. A two-part question, if I may. First, obviously, there have been a lot of consumer behavior changes because of COVID. And I was curious as what behaviors that you think will come back to normal to 2019, for example, and if any of that is basically leading you to reconsider the way that some of your dining rooms are going to be used. In other words, separating the temporary change from consumer behavior using dining rooms and sitting next to each other, what have you, to more permanent ones.

And the second part of the question is from an organizational perspective. Chris, you, obviously, got the head seat at McDonald's at a very auspicious time, with such a major disruptive event coming shortly after you took the job. Where are you in terms of thinking about the right organizational structure from an efficiency and effectiveness point of view, the overall McDonald's organization as we look forward? Thanks.

Chris Kempczinski

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

A

Yeah, thanks, John. On the dine-in, I'm very happy that – and I mentioned this, I think, on our last earnings call, that we are almost completely through our EOTF remodel program. I think that has positioned us very well for the future.

Certainly, one of the questions that I get from franchisees was, hey, we spent on the dining rooms as we went into the pandemic, do we still feel good about that? And my answer is absolutely. In fact, if you look at some of the markets like Australia, for example, that have remained opened that have had dining rooms opened, one of the interesting things is we're seeing kiosk usage in Australia is up by a meaningful amount. And so, I think some of the things that we did with Experience of the Future and the order modifications, the new order channels like kiosks, are playing right to this.

Now, certainly what we're seeing overall, and Kevin mentioned this, is that dine-in as a percent of our business is a smaller amount today because of the growth of drive-thru. I think our view is, as you look out over a longer period of time, we do believe that dine-in is still going to be an important part of the mix. We're not going to be able to get to growing traffic without getting our dine-ins opened. So I think we're still going to see dine-ins as being an important part of the business.

But in terms of enduring behavior, I think whether it's the use of kiosk, the use of mobile, the use of delivery, the use of drive-thru, certainly one of the things is that customers are looking for more of a contactless type of experience. They're looking for more of a digital type of experience, one that they can navigate on their own.

I do think that that behavior is going to be an enduring change, which is why I mentioned that the 3Ds for us, delivery, drive-thru, and digital, are going to be important strategic priorities for us for the foreseeable future, and we'll have more to share about that.

In terms of org changes, I must admit I've not heard my coming in as being described as auspicious, but I'll take auspicious. So thank you for that. But for us, there have been certainly a lot of twists and turn in the COVID road. We are looking at what does all of this mean for the longer-term, but I don't anticipate that there is going to be any major changes that we would do as a result.

As all of you know, we went through a pretty significant G&A rationalization over the last several years, not just in the US but globally. And I think that that put us in a very good position for where we're at now. And when I look at spans and layers and all the typical things that you look at from a G&A perspective, I think we're in pretty good shape there.

But there are going to be areas that we're going to need to think about, and I'll just highlight one. As we move to more virtual learning, how do we think about training and development? And what does that organization need to look like? What's going to be the balance of in-person training that we do versus training that might be done virtually? So there will be some things that we need to think about organizationally, but I would say that those [ph] are on the margins. (53:47) I don't anticipate anything substantive for the broader group.

Mike Cieplak

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

Our next question is from Chris Carril with RBC.

A

Christopher Carril

Analyst, RBC Capital Markets LLC

Thanks, and good morning. In your recent discussions with franchisees, where has been the greatest focus in terms of the opportunities for continued improvement moving forward? So are these conversations mainly focused on continued operational improvements and efficiencies, or is the focus beginning to turn to other demands arising, opportunities from here, like menu innovation or loyalty? Thanks.

Q

Chris Kempczinski

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

Sure. It's definitely on the latter. I think we have done a great job, and credit to franchisees across the globe, around grabbing the opportunity to improve how our restaurants are running. As we were mentioning earlier, we see customer satisfaction scores in, I think, eight out of our top 11 markets are up and up by pretty significant amounts. I think all of that is credit to the operational modifications that we've made.

A

But as we've now, I think, gotten those embedded, there is an opportunity for us to get aggressive in going after share. And that's the marketing war chest that I talked about earlier, but that's getting on the front foot on things like affordability. And so that conversation does vary market-by-market, depending on what's going on. But I think the mentality for us now is that we have gotten the business to a good position, I think, regardless of whether we enter a recession, don't enter a recession, whether we have a resurgence, we don't have a resurgence of the virus, all of those things are going to vary by country. Our mindset needs to be now pivoted strongly toward going after share, because I think that's the opportunity that we have.

Mike Cieplak

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

Our next question is from Matt DiFrisco with Guggenheim.

A

Matthew DiFrisco

Analyst, Guggenheim Securities LLC

Q

Thank you. My question is on delivery. And I just wanted to know about how that's progressed and, as the mobility in the US has improved and people are going to the drive-thru more and getting out and about, if you've seen delivery actually either come down as a percent of sales or absolute dollars.

And then, I just wanted a clarification. I think you said before that 70% of the business was dine-in in the international market, or is that 70% purchases in store, so not necessarily sitting down and dining, but grabbing and going as well from an in-store purchase?

Chris Kempczinski

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

A

Yeah, let's get Kevin in on the action here. Kevin?

Kevin M. Ozan

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

A

Yeah. So on the delivery, I'd say across the board, really in basically every one of our markets, certainly every one of our significant markets, we are seeing delivery as a percent of sales go up. I mentioned in my remarks, Australia specifically growing to about – to almost 10% of sales. And we've got several markets on the international side at that 10% or above even.

The US isn't at 10% of sales, but it has grown significantly during the pandemic. And that's even with drive-thru growing significantly, et cetera. So we're not seeing either drive-thru take away from delivery or delivery take away from drive-thru. Both are growing significantly, and, again, that's a pretty consistent theme around the world, I'd say.

Again, overall delivery as a percent of sales, the US is a little lower certainly than most of our international markets, but growth across the board.

The second question was -

Chris Kempczinski

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

A

The 70%.

Kevin M. Ozan

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

A

Oh yeah, the 70% of restaurants. The 70% that I mentioned of our international markets is in-restaurant ordering, meaning that they were going in the restaurant, some of those were eating in and some of those were taking away. But they were actually ordering at the front counter or at the kiosk in the restaurant versus going through the drive-thru. So it wasn't all dine-in. It was just kind of in-restaurant ordering, which, again, could mean front counter or could mean kiosk.

Mike Cieplak

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

A

Take one last question from Peter Saleh with BTIG.

Peter Saleh

Analyst, BTIG LLC



Great, thanks. Thanks for taking the question. Can you guys talk a little bit about the federal assistance that's been being paid out, if you guys think there's any benefit that you were seeing that you can see in your numbers from the weekly unemployment benefits that the fed has been giving out that's set to expire soon?

And then, just lastly, if there's any comment you guys can make on the financing environment for franchisees, both in the US and globally, their access to capital? Has that been curtailed at all, or any sort of impact given the virus concerns?

Chris Kempczinski

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



Thanks, Peter. I'll take the first part, and then Kevin can close out with the second.

But as you think about the government programs, they've certainly been helpful. When the first checks got cut on the \$600 in the US, I mean, I think the impact of that was pretty apparent very quickly. Now, to some degree, it is built into kind of the trends that we're seeing, but the prospect of it rolling off, I think our expectation would be, for the same reasons that it was stimulative when it first was put in, that there would be some negative implication if that were to roll off.

Now, whether a rolling off of – it went from \$600 to \$200, I don't know if we're that good to parse the details to that degree. But there certainly was a benefit, not just in the US, but we've seen it in a number of other markets around the world, that the government fiscal policy has had a positive benefit on comp.

And then, Kevin, I'll pass it to you for the financing environment.

Kevin M. Ozan

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



Yeah, on the financing for our franchisees, in general, our franchisees are still able to get financing, pretty much around the world as they need it. They have access to capital, certainly, and one of the positives we've seen in the US even. That's why we're actually continuing to do those EOTF projects and that the franchisees want to invest in the businesses. They've got cash flow. They have access to capital and are willing to invest. So we haven't seen any drying up of financing, pretty much around the world.

I'd say that, but I'd also say we do have some international markets where, again, they were closed for potentially a couple months even at a time and some individual franchisees would have taken on some heavy debt over the last several years between EOTF projects, potentially purchasing restaurants, et cetera. So there are individual organizations that I'd say are a little stretched, but it isn't a lack of access to capital. It's really just kind of working through their ratios.

Mike Cieplak

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

Okay. Thank you, Chris and Kevin. Thanks, everyone, for joining. That'll conclude our call. Have a good day.

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

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