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McDonald's Corp. (MCD)

Q3 2020 Earnings Call

CORPORATE PARTICIPANTS

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

MANAGEMENT DISCUSSION SECTION

Operator: Hello and welcome to McDonald's Third Quarter 2020 Investor Conference Call. At the request of McDonald's Corporation, this conference is being recorded.

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. Before we get started, 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 any reconciliations of non-GAAP measures mentioned on today's call with their corresponding GAAP measures. Today's conference call is being webcast and a replay of this call will be available on our website.

We have a couple of updates that we're providing today. We'll cover our third quarter 2020 earnings release on this call, and with me this morning is our Chief Financial Officer, Kevin Ozan. Please note that Kevin's commentary will be limited to prepared remarks, as we'll follow this call with a virtual Investor Update where, beginning at 8:30 AM Central Standard Time, our President and Chief Executive Officer, Chris Kempczinski, will be joined by Kevin and members of our leadership team to provide an update on our strategic priorities, followed by a Q&A session. Registration details can be found on the Investor Events section of our website.

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

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

Thanks, Mike, and good morning, everyone. Since March, we've reminded everyone that we entered the pandemic from a position of strength, with unique advantages that help ensure our success is built to last. This has only become more evident as we look at the significant progress our markets around the world made in the third quarter.

Global comparable sales improved sequentially from Q2 and throughout Q3 with sales down 2.2%, including month-over-month improvement across all segments. Our success comes from leveraging our competitive advantages, the trust our customers have in our brand, our operational strength including our significant drive-thru presence and delivery capabilities, and the unwavering commitment across our system, all grounded in an intense focus on the safety of our customers and crew.

We're pleased with our recovery to-date, but we also understand there inevitably will be more starts and stops with virus resurgences. We're already seeing this in many markets in all parts of the world. As a reminder, we started the third quarter with nearly all of our global restaurants open for business and they remain open today. However, with the resurgences I mentioned, there are numerous instances of government restrictions on operating hours, limited dine-in capacity in most countries, and in some cases, mandated dining room closures.

Around the world, comp sales continue to be driven by check growth from larger orders. This is particularly true with our drive-thru business, which continues to be one of our biggest areas of strength. In most markets, our drive-thru sales percentage peaked during the second quarter and remains elevated when compared to historical norms. This safe and convenient service channel has been especially appealing to customers during the pandemic. Similarly, delivery sales have also increased meaningfully across substantially all of our major markets.

We provided an update on our third quarter comp sales in early October. I'd like to take time now to walk through some of the details for the quarter, followed by a look at October sales trends. Starting with the US, comparable sales were up 4.6% with positive comps in each month of the quarter, including low double-digits in September, marking our highest monthly comp in nearly a decade. Sales comps were also positive across all dayparts for the month of September with continued strength at dinner.

As we mentioned on our Q2 call, we had a sizable marketing war chest to invest in the back half of 2020 to further accelerate recovery. The US began to leverage this marketing investment in a big way to launch our Famous Orders platform during a pivotal time when consumers were looking for reasons to eat out again. The platform was launched with two multicultural brand advocates. First the Travis Scott Meal in September, and building on that success, our second with J Balvin, and there are more to come.

The success of this platform demonstrates how powerful it can be when our brand, digital engagement and affordability are all working together. The US also introduced a twist on a familiar favorite, the Chicken McNuggets. For the first time since the debut of the Chicken McNuggets in 1983, we built on the success seen in many other markets around the world by introducing a spicy flavor profile to a core menu item, all while keeping it simple in our kitchens.

And at the end of October, we introduced a new McCafé Bakery line to our menu. Customers can enjoy an apple fritter, blueberry muffin or a cinnamon roll for breakfast or an afternoon snack with our McCafé coffee. As a reminder, virtually all restaurants in the US have remained open throughout the pandemic, 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.

Moving to our International Operated Markets segments, comp sales were down 4.4% in Q3 with significant improvement over our Q2 comps of negative 41%. Performance varied across markets, as negative comp sales in France, Spain, Germany and the UK were partially offset by positive comp sales in Australia. Despite restricted operating conditions due to a virus resurgence in the State of Victoria, strong drive-thru and delivery sales drove roughly three-quarters of Australia sales, and they grew market share.

Australia has also seen an increase in other digital channels such as our mobile app and self-order kiosks, as customers use contactless ways to order and pay. Comp sales were positive across all major dayparts for the quarter. In Canada, while comp sales were negative for the quarter, we generated momentum and grew market share, as nearly all restaurants reopened in the market. Breakfast recovery continues to lag, with positive comps across dinner, evening and late night, and delivery sales have nearly doubled compared to last year.

In the IOM segment, the European markets were impacted the most by the initial wave of the pandemic earlier this year. The UK, France, Italy and Spain had all restaurants closed for a period of time, and other markets like Germany and Russia were operating with restricted operating hours and limited channels. While all markets were open heading into the third quarter, performance was mixed and we continue to see slower recovery in city centers and other areas that are heavily reliant on tourism in markets like Spain and Italy.

Looking at the UK, sales improved throughout the quarter and comp sales turned positive in August. The UK has been one of our strongest delivery markets for the last couple of years, and that was a key performance driver for the third quarter. We accelerated roll-out with a new delivery partner, Just Eat, and complemented it with a marketing activation plan. Over the past several months, our delivery sales percentage has increased in the UK from high single-digits to mid-teens.

In France and Germany, both markets outperformed broader QSR and gained market share, although sales trends remain negative. In comparison to other markets, France and Germany are more heavily reliant on dine-in sales, with about 70% of their sales from in-restaurant purchases pre-COVID. France is also heavily dependent on travel and tourism, which as I mentioned has been suppressed throughout the pandemic.

And finally, comp sales in the International Developmental Licensed segment were down 10.1%. Comps sequentially improved month-over-month for the quarter with September down just over 5%. Latin America remained the most challenged geography in this segment due to high incidences of COVID in several countries and its less developed drive-thru penetration. Japan once again delivered strong positive comp sales for the quarter. The market captured heightened demand by growing delivery as well as running successful promotions and value offerings.

And in China, we renewed our focus on driving our core menu along with increasing delivery sales and digital memberships. These efforts led to improved results for the quarter, although we still expect recovery to take some time as consumer confidence has been slow to return. In terms of new unit development, China has opened over 300 new restaurants through September. We remain confident in restaurant growth opportunities in China with a plan to open over 400 new restaurants this year.

Turning to October, in the US, sales comps were strong, up mid single-digits with growth across all dayparts. IOM comp sales remained in the negative low single-digits. Australia and the UK both delivered strong comp sales, while France, Spain and Italy weighed on the segment. We expect performance will continue to vary across the IOM markets, given the recent increase in local restrictions in most markets.

As I mentioned before, we expect these starts and stops to be the likely operating environment for as long as the virus is present. Given the safety measures we've put in place and the operational changes we've made to adjust to this new environment, we believe we're well-positioned to successfully navigate through it.

Moving to the P&L, adjusted earnings per share of $2.22 grew 4% in constant currencies for the quarter, after excluding gains on the sale of about 3% of our ownership in McDonald's Japan. A lower effective tax rate and lower G&A compared to last year contributed to the EPS growth. Foreign currency translation also benefited results by $0.03 per share.

While restaurant margin dollars were down 2% in constant currencies, that's a significant recovery compared to second quarter when restaurant margin dollars were down nearly 40% over last year. As the US business returned to positive comps in the quarter, we also grew both franchise and company-owned restaurant margin dollars in the US, which benefited from higher gross profit.

G&A decreased 3% in constant currencies for the quarter, primarily driven by lower incentive compensation accruals and lower travel costs, while we continue to invest in strategic technology initiatives. When looking at the cadence of our G&A spend over the past few years, we've historically spent about 30% of our full-year G&A in the fourth quarter. We expect the Q4 G&A percentage this year to be slightly higher than that, given some one-time investments we're making in renewed brand communications and in actions we're taking to have an even greater impact with our purpose to feed and foster community.

Turning to other operating income and expense, gains on restaurant sales for the full-year are still expected to be down significantly versus last year with minimal restaurant sales expected for the fourth quarter. Our equity in earnings of affiliates for the full-year is projected to be down substantially. And finally, as a reminder, we provided nearly $1 billion of short-term liquidity deferrals to franchisees at the onset of the pandemic. We've now collected roughly half of the deferrals and expect that we'll collect most of the remaining balance over the fourth quarter of 2020 and first quarter of 2021.

As a result, in the third quarter, we reduced $27 million of our bad debt reserve related to rent and royalty deferrals. We expect our full-year effective tax rate to be about 23%, resulting in a fourth quarter tax rate of about 25%. Capital expenditures for 2020 are still expected to be around $1.6 billion, as we plan to open about 950 gross and 300 net new restaurants by year-end. About half of the $1.6 billion is dedicated to the US business, and we remain on track to complete roughly 900 EOTF projects this year.

In October, our board of directors approved a 3% dividend increase to the equivalent of $5.16 annually. This marked over 40 consecutive years of increasing our dividend for shareholders and further reinforces our confidence in the company's long-term strategy. We will continue to manage and utilize our funds in a judicious manner that focuses on ensuring we grow our business, our franchisees remain financially strong and our shareholders are duly rewarded.

Our Velocity Growth Plan served us well over the past few years and gave us confidence in our ability to successfully navigate through this crisis. As our customers' needs have evolved, so too have elements of our path forward. We'll continue to further draw on our solid foundation, unique advantages and core equities to meet the needs of today while building towards a better tomorrow. We look forward to sharing the evolution of our growth strategy later this morning at our virtual Investor Update.

Now, I'll turn it back to Mike for a few closing comments.

Mike Cieplak

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

Thanks, Kevin, and thank you all for joining us. This concludes our third quarter 2020 earnings call. As Kevin just mentioned, our Investor Update presentation begins soon at 8:30 AM Central Standard Time, and we look forward to connecting with you then.

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