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McDonald's (MCD) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	na

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We initiate earnings quality coverage of MCD at 4- (Acceptable).

We do not see significant problems with MCD's accounting. However, we do have some concerns that the growth track the company was on before COVID may not be sustainable once conditions return to normal. We view the refranchising initiative as positive- Ray Kroc himself was credited with saying MCD was a real estate business, not a restaurant business. Also, the Experience of the Future (EOTF) program which has led to the remodeling and technology upgrade of 70% of the US store base through 2019 has likewise helped drive growth. However, this impact will be winding down over the next year and the company has still not been able to drive positive comp guest count growth in the US in either of the last two years. While digital marketing initiatives and a push to delivery have helped drive up the size of the average check, it is clear that US fast food has become a game of picking up pennies in front of a steamroller.

On the numbers front, we note:

- Same-store sales growth has been impressive on the surface at 4.5%-5.9% growth over the last three years. However, MCD's same-store sales base includes all stores that have been in operation for at least 13 months including stores that have been closed for remodeling. We are concerned that both the impact of upgrading stores and the impact of refranchising may be artificially boosting the same-store growth rate which may fade when these trends subside.

- Reported Operating Income is calculated after the "Other Operating (Income)/Expense line which includes non-operational items such as impairments, gains from the sale of restaurants from refranchising, equity income in unconsolidated affiliates and asset dispositions. While non-GAAP EPS typically adjusts out impairments, we suggest taking the whole line out when analyzing operating income. As an example, in the 12/19 quarter, the operating margin improvement falls to 60 bps from the reported 400+ improvement. Likewise, the non-impairment portion has ranged from 5 cps to 16 cps over the last eight quarters. Investors should be considering this when evaluating the quality of any earnings beat.

- The company adopted ASC 842 for accounting for leases at the beginning of 2019. This did not have a material impact on the income statement or retained earnings but moving forward, it will change the classification of some new ground leases to capital leases from operating leases. The impact is not expected to be material in any one year. Also, ASC 842 required the company to report lease income and expense from franchisee leases on a gross basis. While it did not impact absolute franchise margin dollars, it did have the impact of lowering franchise margins by 130 bps in 2019 and overall margins by 70 bps. This is not a material item and it will disappear from comparisons moving forward.

- MCD is a dividend aristocrat and highly prioritizes its dividend in its capital allocation strategy. The dividend is well covered and consumes 70% of free cash flow. Operating cash flow received an unusual boost from lower cash taxes and a decline in receivables but still posted positive growth in 2019 without those items. Capex has been elevated as the company is upgrading the store base and investing in new technology. This is now coming down and should help with the dividend cover. However, the company has taken on debt to aggressively buy back shares. With debt/EBITDA at over 3x based on 2019 numbers, the buyback was likely to be scaled back even before the advent of COVID. Lower share count was adding 2-3% to EPS growth in recent quarters.

Key Trends: Refranchising and International Growth

Three major trends have impacted reported results for the last few years which we discuss below:

Refranchising

Around 2016, MCD began to sell its company-owned restaurants back to franchisees. This has led to a reduction in the number of company-owned locations, as seen in the following table:

	2019	2018	2017	2016	2015
Company-Operated Restaurants	2,636	2,770	3,133	5,669	6,444
Franchised Restaurants	36,059	35,085	34,108	31,230	30,081
Total	38,695	37,855	37,241	36,899	36,525

Franchised restaurants have risen from 82% of the total store count to over 95% in that time frame. This has had a negative impact on revenue as rather than booking the retail sales number, it books the franchise fee/rental payment which is smaller but has a much higher margin.

Overall, we are positive on the refranchising trend as it allows the company to remain more insulated from fluctuations on the restaurant market, focus on branding and securing attractive locations, and leave the management of restaurants to highly-motivated local franchisees who know the local markets.

Focus on Expansion in Foreign Markets

The US fast food market is saturated and highly competitive. MCD has focused on international markets with its expansion plans. The following table shows segemtn sales for the last three years.

Store Count	2019	2018	2017
US	13,846	13,914	14,036
International Operated Markets	10,465	10,263	10,098
International Developmental Licensed Markets & Corporate	14,384	13,678	13,107
	38,695	37,855	37,241

The International Operated segment consists of more developed markets in which the company operates and franchises restaurants such as Australia, Canada, France, Germany, Italy, the Netherlands, Russia, Spain and the UK. The International Developmental Licensed segment includes stores which are operated under a development and affiliate license. This arrangement is used in less developed markets and is similar to a franchise arrangement except the company generally does not contribute any capital in the deal.

MCD opened 1,231 locations in 2019 and closed 391. The company's pre-COVID expansion plans called for spending adding approximately 1,400 restaurants globally in 2020 with the company spending $800 million to open 400 restaurants while developmental licensees and affiliates were expected to provide capital for the remaining 1,000.

The following table shows the impact on segment sales growth from the trends discussed above:

Company-Operated Sales	2019	2018	2017
US	$2,490	$2,665	$3,260
International Operated Markets	$6,334	$6,668	$6,845
International Developmental Licensed Markets & Corporate	$597	$680	$2,614
	$9,421	$10,013	$12,719
Franchised Revenue			
US	$5,353	$5,001	$4,746
International Operated Markets	$5,064	$4,839	$4,271
International Developmental Licensed Markets & Corporate	$1,239	$1,172	$1,084
	$11,656	$11,012	$10,101
Total Revenues			
US	$7,843	$7,666	$8,006
International Operated Markets	$11,398	$11,507	$11,116
International Developmental Licensed Markets & Corporate	$1,836	$1,852	$3,698
	$21,077	$21,025	$22,820

Despite the decline in the number of locations in the US, we see an increase in US franchise revenue being driven by refranchising. We can also see that the growth in franchised locations is more than offsetting the decline in company-operated sites from the refranchising push.

Experience of the Future (EOTF)

In 2018, MCD announced an aggressive modernization program is called Experience fo the Future (EOTF). This involved upgrading the technology at its restaurants to include self-ordering kiosks with touchscreen technology, adding curbside pickup and improving the drive-through operations. As of the end of 2019, EOTF had been rolled out at half of its global locations and 70% penetration in the US with most major markets complete. The company converted 2,000 US locations in 2019 and before COVID, plans called for the conversion of another 1,800 in 2020 at a cost of $1.3 billion.

In addition, the company acquired Dynamic Yield and Apprente in early 2019 which gives its access to new technologies such as quickly incorporated suggested product offerings on its menus to drive higher sales.

US Market Facing Significant Pressure

The US fast food market is mature and highly competitive. MCD has invested heavily in refurbishing and modernizing its stores, incorporating digital initiatives in marketing and product profiling, and partnering with delivery services such as DoorDash to drive sales growth in the US. However, the following table, which shows comparable store sales and guest count growth for each segment for the last three years, illustrates just how difficult it has become to produce meaningful growth in the US. The company defines comparable sales as follows:

> ***"Comparable sales represent sales at all restaurants, whether operated by the Company or by franchisees, in operation at least thirteen months including those temporarily closed. Some of the reasons restaurants may be temporarily closed include reimaging or remodeling, rebuilding, road construction and natural disasters.*** *Comparable sales exclude the impact of currency translation, and, since 2017, also exclude sales from Venezuela due to its hyperinflation. Management generally identifies hyper-inflationary markets*

as those markets whose cumulative inflation rate over a three-year period exceeds 100%. ***Comparable sales are driven by changes in guest counts and average check, which is affected by changes in pricing and product mix. The goal is to achieve a relatively balanced contribution from both guest counts and average check.”***

	2019	2018	2017
US			
Comp Sales Growth	5.0%	2.5%	3.6%
Comp Guest Count	-1.9%	-2.2%	1.0%
International Operated Markets			
Comp Sales Growth	6.1%	6.1%	5.6%
Comp Guest Count	3.5%	2.8%	2.7%
International Developmental Licensed markets & Corporate			
Comp Sales Growth	7.2%	5.6%	8.0%
Comp Guest Count	2.2%	1.0%	2.5%
Total			
Comp Sales Growth	5.9%	4.5%	5.3%
Comp Guest Count	1.0%	0.2%	1.9%

The US has produced relatively impressive comparable store sales growth for the last three years when viewed at the surface level. However, in both of the last two years, comparable-store guest count has declined by roughly 2%. In the fourth quarter conference call, management attributed this to 60% mix and 40% higher pricing. However, this is also being impacted by the move to delivery which sees multiple customers ordering on the same ticket. Delivery has gone from $1 billion in revenue to $3 billion in just the last three years. CEO Chris Kempczinki explained in the fourth quarter conference call:

“One of the things that I do feel good about with the U.S. is when you look at the check growth that we’ve gotten, it’s really come through a number of different things. There has not been sort of a one-trick pony on that. We’re seeing the majority of that growth is coming through mix as opposed to just kind of straight menu price. But then as you decompose mix, you’ve got a number of factors that are worked there. ***You’ve got delivery, which is delivering 2x the average check of a regular order. You have Dynamic Yield,***

> ***which is typically leading to add-ons to an order. You have our self-order kiosk, where we know that people tend to have larger orders when they do self-order kiosk. You've seen some of our promotional items like donut sticks, D $1 $2 $3 as a value, which are really driving add-on activity.*** *So I think, for me, I do feel better about how we went after check growth in 2019 because it was heavily mix-driven from that.* ***But there is a pricing element to this. The inflation that we're seeing out there, particularly on the labor side that does get priced through and so I think as we head into 2020, the conversation we've been having with franchisees, which gets back to the opening question, is we've just got to make sure that we have balance. We need to have a balance between check growth and we need to get to transaction growth, and that's what everybody in the U.S. is working toward right now."***

While the company has been able to drive positive comp sales growth in the US, the persistence of negative comp guest growth is concerning as it illustrates the degree to which the US fast food market has become a zero-sum game for participants.

We also want to revisit the company's definition of comparable sales. A store is included in the base after only 13 months of operation and includes stores that have been closed. Remember that the company has been rapidly refranchising and remodeling stores for the last three years. We would expect a refranchised store to see an uptick in activity when a motivated new manager takes the helm. Also, since the company includes stores that have been closed for remodeling in the base, this would appear to significantly boost same-store sales growth the year the store is reopened as the previous period would have reduced sales from the temporary closure and the current period would benefit from higher sales from a remodeled store. To the extent current same-store sales trends have benefitted from these trends, it could be giving investors a false impression of what core growth will be when the refranchising and EOTF programs wind down in future quarters.

Other Income/Expense Distorts Results

MCD's "Other Operating (Income)/Expense" line on its income statement is reported above operating income and it can have a very material impact on results. The components of the line item are shown below:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Impairment and Other (Income) Expense	-$5.9	$1.6	$78.3	$0.3
(Gains) on Sales of Restaurant Businesses	-$37.1	-$17.4	-$43.9	-$29.1
Equity in (Earnings) of Unconsolidated Affiliates	-$41.8	-$42.8	-$34.1	-$35.1
Asset Dispositions and Other (Income) Expenses	-$15.3	$9.1	$22.2	$7.1
	-$100.1	-$49.5	$22.5	-$56.8

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Impairment and Other (Income) Expense	$137.9	$0.5	$91.7	$1.6
(Gains) on Sales of Restaurant Businesses	-$47.4	-$68.0	-$92.2	-$96.5
Equity in (Earnings) of Unconsolidated Affiliates	-$35.3	-$38.6	-$35.0	-$42.6
Asset Dispositions and Other (Income) Expenses	$32.2	-$4.7	-$29.4	-$11.0
	$87.4	-$110.8	-$64.9	-$148.5

- The Impairment and Other (Income)/Expense line includes mainly writedowns from past investments. This is clearly not an operational item and the company typically adjusts it out of non-GAAP results.

- Gains on Sales of Restaurant Businesses relates to the sale of restaurants, mostly from refranchising activity in the US. While we would consider these operational gains which benefit shareholders, they can be volatile and they are on the wane as refranchising activity slows down. Thus, we would argue they should be excluded from results when analyzing operating income margins and operational EPS.

- Equity in Earnings of Unconsolidated Affiliates relates to activity in affiliates and partnerships in businesses in which the company participates but does not control. We would agree that this line item could be viewed as operational in nature. However, since 2016, it has exhibited some volatility in particular quarters that were material enough to distort reported EPS.

- Asset Dispositions is volatile and we view this as a clear non-operational item that should be excluded when analyzing operating margins and EPS.

The below table shows operating margin and EPS with and without the above items:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Sales	$5,349.0	$5,430.6	$5,341.3	$4,955.6
Operating Income	$2,292.6	$2,409.3	$2,273.9	$2,094.0
Operating Margin	42.9%	44.4%	42.6%	42.3%
Adjusted Operating Income*	$2,192.5	$2,359.8	$2,296.4	$2,037.2
Adjusted Operating Margin	41.0%	43.5%	43.0%	41.1%
Reported Non-GAAP EPS	$1.97	$2.11	$2.05	$1.78
EPS Impact of Unadjusted Items*8	$0.10	$0.05	$0.06	$0.06

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Sales	$5,163.0	$5,369.4	$5,353.9	$5,138.9
Operating Income	$1,999.5	$2,417.7	$2,262.3	$2,143.1
Operating Margin	38.7%	45.0%	42.3%	41.7%
Adjusted Operating Income*	$2,086.9	$2,306.9	$2,197.4	$1,994.6
Adjusted Operating Margin	40.4%	43.0%	41.0%	38.8%
Reported Non-GAAP EPS	$1.97	$2.16	$1.99	$1.79
EPS Impact of Unadjusted Items**	$0.05	$0.11	$0.16	$0.15

**Adjusted Operating Income is operating income before the "Other Operating (Income)/Expense line.*

*** The EPS Impact of Unadjusted items is the benefit from Gains on Sales of Restaurant Businesses, Equity in Earnings of Unconsolidated Affiliates, and Asset Dispositions. Non-GAAP EPS typically adjusts out Impairment and Other (Income) Expenses.*

We see that these other items have a material impact on the movement in reported operating income margin every quarter. In the case of the 12/19 period, reported operating income improved by 420 bps. This falls to 60 bps when removing the impact of the Other Operating (Income)/Expense line. While Non-GAAP EPS does typically adjust out the Impairment component from Other Operating (Income)/Expense, the remaining items have a volatile and material impact on non-GAAP EPS and should be taken into consideration every quartet to determine the quality of any earnings beat.

ASC 842 Impact

Beginning in 2019, MCD adopted ASC Topic 842 in accounting for leases. The company is heavily involved in both leasing locations to franchisees as well as leasing both land and buildings for future locations. MCD elected to retain the classification of existing leases and as a result, the adoption had little immediate impact on the income statement and did not require a significant adjustment to retained earnings. However, as it enters into future ground leases, many that would have been classified as operating leases in the past are expected to now be classified as finance leases which will change the timing and classification of lease expense between operating income and lease expense. The impact is not expected to be material in any one year.

One change related to leases that was noticeable in results was the new requirement to present the straight-line impact of fixed rent escalations on a gross basis in the presentation of sub-lease income and lease expense related to franchisees. This had the impact of increasing franchise revenue and franchise expense by like amounts. While this has no impact on absolute franchise margin dollars, it does pressure the margin percentage. The following table shows the calculation of franchise margin for the last three years:

	2019	2018	2017
Franchised Revenue			
US	$5,353	$5,001	$4,746
International Operated Markets	$5,064	$4,839	$4,271
International Developmental Licensed Markets & Corporate	$1,239	$1,172	$1,084
	$11,656	$11,012	$10,101
Franchised Margin			
US	$4,227	$4,070	$3,913
International Operated Markets	$4,018	$3,829	$3,365
International Developmental Licensed Markets & Corporate	$1,210	$1,140	$1,034
	$9,455	$9,039	$8,312
Franchised Margin %			
US	79.0%	81.4%	82.4%
International Operated Markets	79.3%	79.1%	78.8%
International Developmental Licensed Markets & Corporate	97.7%	97.3%	95.4%
	81.1%	82.1%	82.3%

Franchise margin dollars showed a steady increase in 2019 while margins fell by 100 bps. Management estimated that the adoption of ASC 842 reduced franchise margins by 130 bp and total company margins by 70 bps. This is not a material concern and it will disappear in margin comparisons going forward.

Adding to Debt to Buy Back Shares

MCD is a dividend aristocrat and is strongly committed to paying and growing its dividend. Cash flow is more than adequate to do this into the foreseeable future. However, the aggressive buyback is more of a question. The following table shows cash flow information for the last four years:

	12/31/2019	12/31/2018	12/31/2017	12/31/2016
T12 Operating Cash Flow	$8,122	$6,967	$5,551	$6,060
T12 Capex	$2,935	$2,843	$1,931	$1,931
T12 Free Cash Flow	$5,188	$4,123	$3,621	$4,129
T12 Dividends	$3,582	$3,256	$3,089	$3,058
Dividend % of Free Cash	69.0%	79.0%	85.3%	74.1%
T12 Net Stock Repurchases	$4,976	$5,208	$4,686	$11,171
Cash Flow after Buyback	-$3,371	-$4,340	-$4,154	-$10,100

Operating cash flow grew by $1.1 billion. This was boosted by an approximate $500 billion beneficial swing in receivables and $145 million in lower cash tax payments. However, capex has also been elevated as the company has invested heavily in its EOTF initiative and opened new locations. Pre-COVID, MCD was forecasting $2.4 billion in capex in 2020 which includes $1.3 billion in the US for 1,800 EOTF projects and the previously mentioned $800 million to open 400 new restaurants globally. This is a material deceleration from the 2019 spending rate. While these plans are certain to be altered significantly, in a normal year going forward it is reasonable to expect the dividend to consume in the mid-70% range of free cash flow.

However, as the table above also shows, the company has more than spent the cash flow after dividend on buying back shares. Over the last three years, cash from the exercise of stock options has ranged from $350 million to $450 million while the company has received $350 million to $975 million from the sale of restaurants. However, this has not been sufficient to cover the difference and are not reliable sources of cash. Net Debt to EBITDA has crept up to 3.1 from 2.7 two years ago. The buyback is listed third in the company's priority for capital allocation and we would expect to see it pared back soon, especially in light of the current conditions. Share count reduction is, unfortunately, a sizeable portion of reported earnings growth as illustrated in the following table:

	12/31/2019	09/30/2019	06/30/2019	03/31/2019
Non-GAAP EPS Growth	0.0%	-2.3%	3.0%	-0.6%
Share Count Growth	-2.7%	-2.0%	-2.3%	-3.4%

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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