MCDONALDS CORP
Form 10-Q
November 04, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 1-5231
McDONALD'S CORPORATION
(Exact Name of Registrant as Specified in Its Charter)

Delaware	36-2361282
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
One McDonald's Plaza Oak Brook, Illinois	60523
(Address of Principal Executive Offices)	(Zip Code)

(630) 623-3000
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

830,443,627
(Number of shares of common stock outstanding as of September 30, 2016)

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McDONALD’S CORPORATION

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PART I – FINANCIAL INFORMATION
Item 1. Financial Statements
CONDENSED CONSOLIDATED BALANCE SHEET

In millions, except per share data	(unaudited) September 30, 2016	December 31, 2015
Assets		
Current assets		
Cash and equivalents	$ 2,266.7	$ 7,685.5
Accounts and notes receivable	1,349.8	1,298.7
Inventories, at cost, not in excess of market	90.5	100.1
Prepaid expenses and other current assets	595.1	558.7
Total current assets	4,302.1	9,643.0
Other assets		
Investments in and advances to affiliates	878.0	792.7
Goodwill	2,504.7	2,516.3
Miscellaneous	1,816.4	1,869.1
Total other assets	5,199.1	5,178.1
Property and equipment		
Property and equipment, at cost	37,931.1	37,692.4
Accumulated depreciation and amortization	(14,945.4)	(14,574.8)
Net property and equipment	22,985.7	23,117.6
Total assets	$ 32,486.9	$ 37,938.7
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable	$ 852.2	$ 874.7
Dividends payable	772.9	—
Income taxes	561.3	154.8
Other taxes	295.3	309.0
Accrued interest	263.6	233.1
Accrued payroll and other liabilities	1,731.4	1,378.8
Total current liabilities	4,476.7	2,950.4
Long-term debt	26,007.0	24,122.1
Other long-term liabilities	2,248.5	2,074.0
Deferred income taxes	1,378.8	1,704.3
Shareholders' equity		
Preferred stock, no par value; authorized – 165.0 million shares; issued – none	—	—
Common stock, $.01 par value; authorized – 3.5 billion shares; issued – 1,660.6 million shares	16.6	16.6
Additional paid-in capital	6,712.8	6,533.4
Retained earnings	45,030.0	44,594.5
Accumulated other comprehensive income	(2,622.6)	(2,879.8)
Common stock in treasury, at cost; 830.2 and 753.8 million shares	(50,760.9)	(41,176.8)
Total shareholders' equity	(1,624.1)	7,087.9
Total liabilities and shareholders' equity	$ 32,486.9	$ 37,938.7

See Notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENT OF INCOME
(UNAUDITED)

	Quarters Ended September 30,		Nine Months Ended September 30,	
In millions, except per share data	2016	2015	2016	2015
Revenues				
Sales by Company-operated restaurants	$3,972.1	$4,282.9	$11,642.2	$12,458.1
Revenues from franchised restaurants	2,452.0	2,332.2	6,950.8	6,613.6
Total revenues	6,424.1	6,615.1	18,593.0	19,071.7
Operating costs and expenses				
Company-operated restaurant expenses	3,239.5	3,607.7	9,662.9	10,558.3
Franchised restaurants—occupancy expenses	437.6	416.1	1,283.6	1,230.7
Selling, general & administrative expenses	582.9	584.0	1,757.0	1,759.2
Other operating (income) expense, net	26.8	(23.0)	114.0	258.4
Total operating costs and expenses	4,286.8	4,584.8	12,817.5	13,806.6
Operating income	2,137.3	2,030.3	5,775.5	5,265.1
Interest expense	221.4	160.9	663.6	457.4
Nonoperating (income) expense, net	11.4	(9.0)	(19.2)	(37.2)
Income before provision for income taxes	1,904.5	1,878.4	5,131.1	4,844.9
Provision for income taxes	629.1	569.2	1,638.0	1,521.8
Net income	$1,275.4	$1,309.2	$3,493.1	$3,323.1
Earnings per common share-basic	$1.52	$1.41	$4.04	$3.51
Earnings per common share-diluted	$1.50	$1.40	$4.01	$3.49
Dividends declared per common share	$0.89	$0.85	$2.67	$2.55
Weighted-average shares outstanding-basic	841.4	930.3	864.7	947.9
Weighted-average shares outstanding-diluted	847.7	934.8	871.8	952.7

See Notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)

In millions	Quarters Ended September 30, 2016	Quarters Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Net income	$1,275.4	$1,309.2	$3,493.1	$3,323.1
Other comprehensive income (loss), net of tax				
Foreign currency translation adjustments:				
Gain (loss) recognized in accumulated other comprehensive income (AOCI), including net investment hedges	50.7	(492.6)	255.0	(1,083.1)
Reclassification of (gain) loss to net income	—	—	18.3	0.2
Foreign currency translation adjustments-net of tax benefit (expense) of $30.4, $0.3, $(66.9) and $(92.6)	50.7	(492.6)	273.3	(1,082.9)
Cash flow hedges:				
Gain (loss) recognized in AOCI	(1.3)	1.7	(8.4)	13.7
Reclassification of (gain) loss to net income	1.8	(8.3)	(10.2)	(23.0)
Cash flow hedges-net of tax benefit (expense) of $(0.1), $3.8 and $10.6, $5.3	0.5	(6.6)	(18.6)	(9.3)
Defined benefit pension plans:				
Gain (loss) recognized in AOCI	(0.1)	—	(0.9)	(1.4)
Reclassification of (gain) loss to net income	1.1	1.7	3.4	5.8
Defined benefit pension plans-net of tax benefit (expense) of $0.1, $0.1 and $0.1, $0.7	1.0	1.7	2.5	4.4
Total other comprehensive income (loss), net of tax	52.2	(497.5)	257.2	(1,087.8)
Comprehensive income (loss)	$1,327.6	$811.7	$3,750.3	$2,235.3

See Notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

	Quarters Ended September 30,		Nine Months Ended September 30,	
In millions	2016	2015	2016	2015
Operating activities				
Net income	$1,275.4	$1,309.2	$3,493.1	$3,323.1
Adjustments to reconcile to cash provided by operations				
Charges and credits:				
Depreciation and amortization	370.6	387.7	1,137.6	1,166.0
Deferred income taxes	(216.0)	(0.1)	(374.7)	15.2
Share-based compensation	34.3	29.0	102.1	76.7
Other	2.9	27.2	189.1	289.3
Changes in working capital items	783.9	194.4	697.5	290.1
Cash provided by operations	2,251.1	1,947.4	5,244.7	5,160.4
Investing activities				
Capital expenditures	(405.3)	(412.7)	(1,149.6)	(1,221.2)
Sales and purchases of restaurant businesses and property sales	103.9	38.2	421.3	136.8
Other	(49.7)	(44.0)	(82.4)	(29.8)
Cash used for investing activities	(351.1)	(418.5)	(810.7)	(1,114.2)
Financing activities				
Net short-term borrowings	(80.0)	170.2	(742.9)	131.4
Long-term financing issuances	0.6	1.4	3,372.7	4,229.2
Long-term financing repayments	(5.7)	(6.2)	(819.6)	(1,052.9)
Treasury stock purchases	(1,969.8)	(2,392.3)	(9,662.2)	(4,554.1)
Common stock dividends	(745.1)	(789.1)	(2,285.2)	(2,416.4)
Proceeds from stock option exercises	36.1	35.7	249.9	170.9
Excess tax benefit on share-based compensation	—	4.6	—	30.0
Other	(11.8)	(2.9)	(3.9)	(22.4)
Cash used for financing activities	(2,775.7)	(2,978.6)	(9,891.2)	(3,484.3)
Effect of exchange rates on cash and cash equivalents	14.4	(96.3)	38.4	(187.3)
Cash and equivalents increase (decrease)	(861.3)	(1,546.0)	(5,418.8)	374.6
Cash and equivalents at beginning of period	3,128.0	3,998.5	7,685.5	2,077.9
Cash and equivalents at end of period	$2,266.7	$2,452.5	$2,266.7	$2,452.5

See Notes to condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Basis of Presentation

The accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements contained in the Company’s December 31, 2015 Annual Report on Form 10-K. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation have been included. The results for the quarter and nine months ended September 30, 2016 do not necessarily indicate the results that may be expected for the full year.

Restaurant Information

The following table presents restaurant information by ownership type:

Restaurants at September 30,	2016	2015
Conventional franchised	21,456	21,009
Developmental licensed	5,742	5,348
Foreign affiliated	3,361	3,494
Total Franchised	30,559	29,851
Company-operated	6,056	6,554
Systemwide restaurants	36,615	36,405

The results of operations of restaurant businesses purchased and sold in transactions with franchisees were not material either individually or in the aggregate to the condensed consolidated financial statements for the periods prior to purchase and sale.

Per Common Share Information

Diluted earnings per common share is calculated using net income divided by diluted weighted-average shares. Diluted weighted-average shares include weighted-average shares outstanding plus the dilutive effect of share-based compensation, calculated using the treasury stock method, of 6.3 million shares and 4.5 million shares for the quarters 2016 and 2015, respectively, and 7.1 million shares and 4.8 million shares for the nine months 2016 and 2015, respectively. Stock options that would have been antidilutive, and therefore were not included in the calculation of diluted weighted-average shares, totaled 4.2 million shares and 9.1 million shares for the quarters 2016 and 2015, respectively, and 1.2 million shares and 9.4 million shares for the nine months 2016 and 2015, respectively.

In the second quarter 2016, the Company entered into an Accelerated Share Repurchase agreement (“ASR”) to purchase up to $2.6 billion of the Company's common stock and received an initial delivery of 16.2 million shares, which represented 80% of the total shares the Company expected to receive based on the market price at the time of initial delivery. In July 2016, the purchase period for this ASR ended, and an additional 5.1 million shares were received.

In September 2016, McDonald's Board of Directors declared a fourth quarter dividend of $0.94 per share of common stock, resulting in $772.9 million of dividends payable in December 2016.

Fair Value Measurements

The Company measures certain financial assets and liabilities at fair value. Fair value disclosures are reflected in a three-level hierarchy, maximizing the use of observable inputs and minimizing the use of unobservable inputs. The Company did not have any significant changes to the valuation techniques used to measure fair value as described in the Company's December 31, 2015 Annual Report on Form 10-K.

At September 30, 2016, the fair value of the Company’s debt obligations was estimated at $28.8 billion, compared to a carrying amount of $26.0 billion. The fair value was based upon quoted market prices, Level 2 within the valuation hierarchy. The carrying amounts of cash and equivalents, short-term investments and notes receivable approximate fair value.

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Financial Instruments and Hedging Activities

The Company is exposed to global market risks, including the effect of changes in interest rates and foreign currency fluctuations. The Company uses foreign currency denominated debt and derivative instruments to mitigate the impact of these changes. The Company does not hold or issue derivatives for trading purposes.

The following table presents the fair values of derivative instruments included on the condensed consolidated balance sheet:

In millions	Derivative Assets September 30, 2016	Derivative Assets December 31, 2015	Derivative Liabilities September 30, 2016	Derivative Liabilities December 31, 2015
Total derivatives designated as hedging instruments	$9.7	$ 60.9	$(11.3)	$ (38.9)
Total derivatives not designated as hedging instruments	131.1	144.4	(16.6)	(5.5)
Total derivatives	$140.8	$ 205.3	$(27.9)	$ (44.4)

The following table presents the pretax amounts affecting income and other comprehensive income ("OCI") for the nine months ended September 30, 2016 and 2015, respectively:

	Gain (Loss) Recognized in Accumulated OCI		Gain (Loss) Reclassified into Income from Accumulated OCI		Gain (Loss) Recognized in Income on Derivative(1)	
In millions	2016	2015	2016	2015	2016	2015
Cash Flow Hedges	$(13.6)	$19.7	$15.6	$34.3	—	$22.9
Net Investment Hedges	$(96.5)	$493.5	$(18.3)	$(0.2)		
Undesignated derivatives					$(4.1)	$19.5

(1) Includes amounts excluded from effectiveness testing, ineffectiveness, and undesignated gains (losses).

• Fair Value Hedges

The Company enters into fair value hedges that convert a portion of its fixed-rate debt into floating-rate debt by use of interest rate swaps. At September 30, 2016, $2.2 billion of the Company's outstanding fixed-rate debt was effectively converted. For the nine months ended September 30, 2016, the Company recognized a $2.2 million gain on fair value interest rate swaps, which was exactly offset by a corresponding loss in the fair value of the hedged debt instruments.

• Cash Flow Hedges

The Company enters into cash flow hedges to reduce the exposure to variability in certain expected future cash flows. To protect against the reduction in value of forecasted foreign currency cash flows (such as royalties denominated in foreign currencies), the Company uses foreign currency forwards and foreign currency options to hedge a portion of anticipated exposures. The hedges cover the next 18 months for certain exposures and are denominated in various currencies. As of September 30, 2016, the Company had derivatives outstanding with an equivalent notional amount of $676.5 million that hedged a portion of forecasted foreign currency denominated royalties.

Based on market conditions at September 30, 2016, the $1.4 million in cumulative cash flow hedging gains, after tax, is not expected to have a significant effect on earnings over the next 12 months.

• Net Investment Hedges

The Company primarily uses foreign currency denominated debt (third party and intercompany) to hedge its investments in certain foreign subsidiaries and affiliates. Realized and unrealized translation adjustments from these hedges are included in shareholders' equity in the foreign currency translation component of OCI and offset translation adjustments on the underlying net assets of foreign subsidiaries and affiliates, which also are recorded in OCI. As of September 30, 2016, $8.4 billion of the Company's third party foreign currency denominated debt, $3.3 billion of intercompany foreign currency denominated debt and $297.7 million of derivatives were designated to hedge investments in certain foreign subsidiaries and affiliates.

• Credit Risk

The Company is exposed to credit-related losses in the event of non-performance by its derivative counterparties. The Company did not have significant exposure to any individual counterparty at September 30, 2016 and has master agreements that contain netting arrangements. For financial reporting purposes, the Company presents gross derivative balances in the financial statements and supplementary data, including for counterparties subject to netting arrangements. Some of these agreements also require each party to post collateral if credit ratings fall below, or aggregate exposures exceed, certain contractual limits. At September 30, 2016, the Company was required to post an immaterial amount of collateral due to certain derivatives having negative positions. The Company's counterparties were not required to post collateral on any derivative position, other than on hedges of certain of the Company’s supplemental benefit plan liabilities where the counterparties were required to post collateral on their liability positions.

Segment Information

The Company franchises and operates McDonald’s restaurants in the global restaurant industry. The following reporting segments reflect how management reviews and evaluates operating performance.

- U.S. - the Company's largest segment.
- International Lead Markets - established markets including Australia, Canada, France, Germany, the U.K. and related markets.
- High Growth Markets - markets the Company believes have relatively higher restaurant expansion and franchising potential including China, Italy, Korea, Poland, Russia, Spain, Switzerland, the Netherlands and related markets.
- Foundational Markets & Corporate - the remaining markets in the McDonald's system, each of which the Company believes have the potential to operate under a largely franchised model. Corporate activities are also reported within this segment.

The following table presents the Company’s revenues and operating income by segment.

	Quarters Ended September 30,		Nine Months Ended September 30,	
In millions	2016	2015	2016	2015
Revenues				
U.S.	$2,072.5	$2,189.3	$6,215.2	$6,341.6
International Lead Markets	1,881.2	1,971.6	5,452.5	5,699.3
High Growth Markets	1,651.3	1,645.2	4,644.1	4,714.4
Foundational Markets & Corporate	819.1	809.0	2,281.2	2,316.4
Total revenues	$6,424.1	$6,615.1	$18,593.0	$19,071.7
Operating Income				
U.S.	$977.5	$902.1	$2,836.6	$2,559.7
International Lead Markets	754.1	739.5	2,127.2	2,011.6
High Growth Markets	320.1	297.3	814.7	639.3
Foundational Markets & Corporate	85.6	91.4	(3.0)	54.5
Total operating income	$2,137.3	$2,030.3	$5,775.5	$5,265.1

Recently Issued Accounting Standards

Employee Share-Based Payment Accounting

In March 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-09, “Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.” The goal of this update is to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. This update is effective beginning January 1, 2017 with early adoption permitted.

The Company elected to early adopt ASU 2016-09 in the second quarter 2016, which required reflection of any adjustments as of January 1, 2016. The primary impact of adoption was the recognition of excess tax benefits as a reduction to the provision for income taxes for all periods reported in fiscal year 2016.

Additional amendments to ASU 2016-09 related to income taxes and minimum statutory withholding tax requirements had no impact to retained earnings, where the cumulative effect of these changes are required to be recorded. The Company also elected to continue estimating forfeitures when determining the amount of compensation costs to be recognized in each period.

The presentation requirements for cash flows related to excess tax benefits were applied prospectively; as such, prior years have not been restated. The presentation requirements for cash flows related to employee taxes paid for withheld shares had no impact to any of the periods presented in the consolidated statement of cash flows, since such cash flows have historically been presented in financing activities.

Lease Accounting

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842),” to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. The Company anticipates ASU 2016-02 to have a material impact on the consolidated balance sheet. The impact on the Company’s consolidated statement of income is currently being evaluated. The impact of ASU 2016-02 is non-cash in nature, as such, it will not affect the Company’s cash position.

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Revenue Recognition

In May 2014, the FASB issued guidance codified in ASC 606, “Revenue Recognition - Revenue from Contracts with Customers,” which amends the guidance in former ASC 605, “Revenue Recognition.” In July 2015, the FASB made a decision to defer by one year the effective date of its new standard to January 1, 2018, although early adoption is permitted as of January 1, 2017. The Company is currently evaluating the impact of ASC 606.

Subsequent Events

The Company evaluated subsequent events through the date the financial statements were issued and filed with the Securities and Exchange Commission. There were no subsequent events that required recognition or disclosure.

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Overview

The Company franchises and operates McDonald’s restaurants. Of the 36,615 restaurants in 120 countries at September 30, 2016, 30,559 were licensed to franchisees (comprised of 21,456 franchised to conventional franchisees, 5,742 licensed to developmental licensees and 3,361 licensed to foreign affiliates (“affiliates”) – primarily in Japan) and 6,056 were operated by the Company.

Under McDonald's conventional franchise arrangement, franchisees provide a portion of the capital required by initially investing in the equipment, signs, seating and décor of their restaurant business, and by reinvesting in the business over time. The Company owns the land and building or secures long-term leases for both Company-operated and conventional franchised restaurant sites. This maintains long-term occupancy rights, helps control related costs and assists in alignment with franchisees enabling restaurant performance levels that are among the highest in the industry. In certain circumstances, the Company participates in the reinvestment for conventional franchised restaurants in an effort to accelerate implementation of certain initiatives.

Under McDonald's developmental license arrangement, licensees provide capital for the entire business, including the real estate interest, and the Company has no capital invested. In addition, the Company has an equity investment in a limited number of affiliates that invest in real estate and operate or franchise restaurants within a market.

McDonald's is primarily a franchisor and believes franchising is paramount to delivering great-tasting food, locally-relevant customer experiences and driving profitability. Franchising enables an individual to own a restaurant business and maintain control over staffing, purchasing, marketing and pricing decisions, while also benefiting from the financial strength and global experience of McDonald's. However, directly operating restaurants is important to being a credible franchisor and provides Company personnel with restaurant operations experience. In Company-operated restaurants, and in collaboration with franchisees, McDonald's further develops and refines operating standards, marketing concepts and product and pricing strategies, so that only those that the Company believes are most beneficial are introduced in the restaurants. McDonald's continually reviews its mix of Company-operated and franchised restaurants to help optimize overall performance, with a goal to be 95% franchised over the long term.

The Company’s revenues consist of sales by Company-operated restaurants and fees from restaurants operated by franchisees. Revenues from conventional franchised restaurants include rent and royalties based on a percent of sales along with minimum rent payments, and initial fees. Revenues from restaurants licensed to affiliates and developmental licensees include a royalty based on a percent of sales, and generally include initial fees. Fees vary by type of site, amount of Company investment, if any, and local business conditions. These fees, along with occupancy and operating rights, are stipulated in franchise/license agreements that generally have 20-year terms.

The business is structured with segments that combine markets with similar characteristics and opportunities for growth. Significant reportable segments include the United States ("U.S."), International Lead Markets and High Growth Markets. In addition, throughout this report we present the Foundational Markets & Corporate segment which includes markets in over 80 countries, as well as Corporate activities. For the nine months ended September 30, 2016, the U.S., the International Lead Markets and the High Growth Markets accounted for 33%, 29% and 25% of total revenues, respectiv