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McDonald's Corp. (MCD)

Q2 2018 Earnings Call

CORPORATE PARTICIPANTS

Mike Flores

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

Stephen J. Easterbrook

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

Kevin M. Ozan

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

OTHER PARTICIPANTS

Sara Harkavy Senatore

Analyst, Sanford C. Bernstein & Co. LLC

Andrew Charles

Analyst, Cowen and Company, LLC

Jeffrey Bernstein

Analyst, Barclays Capital, Inc.

Brian Bittner

Analyst, Oppenheimer & Co., Inc.

David E. Tarantino

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

Karen Holthouse

Analyst, Goldman Sachs & Co. LLC

Nicole Miller Regan

Analyst, Piper Jaffray & Co.

Will Slabaugh

Analyst, Stephens Inc.

Alton K. Stump

Analyst, Longbow Research LLC

Gregory R. Francfort

Analyst, Bank of America Merrill Lynch

Matthew DiFrisco

Analyst, Guggenheim Securities LLC

John Glass

Analyst, Morgan Stanley & Co. LLC

John William Ivankoe

Analyst, JPMorgan Securities LLC

Chris O'Cull

Analyst, Stifel, Nicolaus & Co., Inc.

Matthew Robert McGinley

Analyst, Evercore Group LLC

MANAGEMENT DISCUSSION SECTION

Operator: Hello and welcome to McDonald's Second Quarter 2018 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 Flores, Investor Relations Officer for McDonald's Corporation. Mr. Flores, you may begin.

Mike Flores

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

Hello, everyone, and thank you for joining us. With me on the call today are President and Chief Executive Officer, Steve Easterbrook; and Chief Financial Officer, Kevin Ozan. Today's conference call is being webcast live and recorded for replay by webcast.

Now, before I turn it over to Steve, I want to remind everyone that the forward-looking statements in our earnings release and 8-K filing also apply to our comments. Both documents are available on www.investor.McDonalds.com, as are reconciliations of any non-GAAP financial measures mentioned on today's call with their corresponding GAAP measures.

And now, I'd like to turn it over to Steve.

Stephen J. Easterbrook

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

Thank you, Mike. Good morning, everyone. We had another good quarter of results as we continue to execute our Velocity Growth Plan. Our customers tell us they value and appreciate the moves we're making to elevate the McDonald's experience. As we discussed a quarter ago, we're confident in our strategy as we continue the day-to-day work of running great restaurants and as we put in place of the most promising platforms for long-term sustained growth.

Our International Lead markets offer an important illustration of the successful approach which reinforces the belief in our plan. Markets such as UK, Canada and France continue to perform well with strong sales and guest count growth. These markets began establishing the foundation for today's success several years ago. They developed realistic plans guided by rich local insights about our customers and initiated programs to offer delicious food, compelling value and great running modernized restaurants.

They also gained alignment with franchisees and enhanced engagement with restaurant employees, vital steps toward integrated and effective execution. The result is that our customers visiting these restaurants today can easily see our commitment to providing them with a great experience. With a solid platform in place, these markets also have been more effective in activating additional initiatives for growth, such as digital and delivery.

We've demonstrated our ability to transfer winning ideas across our markets and that's another reason for the continued confidence in our business. As I mentioned last quarter, the U.S. is in the first year of executing an ambitious and holistic three year plan aligned with the Velocity strategy. Many of the initiatives in the U.S. have been key drivers of the success in our international markets.

The U.S. business completed over 1,300 more Experience of the Future, or as we call it, EOTF, restaurant conversions in quarter two. While this aggressive pace comes with some limited downtime, it essentially means we're providing customers with an improved and modernized experience in roughly 10 additional restaurants every day. To-date, we have a total of over 5,000 EOTF restaurants, which is more than one-third of the U.S. estate, offering elevated hospitality and convenience to our customers.

While EOTF brings dramatic improvements to our restaurants, it is not the only major initiative the U.S. business executed during the quarter. We also successfully completed the rollout of cooked right when ordered quarter pound burgers using fresh beef, continued to redefine convenience with delivery and refined our value offering, including our \$1 \$2 \$3 national value platform.

We know the combination of key initiatives to improve the experience for our customers makes a difference. Restaurant success saw in executing multiple elements of the U.S. plan are achieving high sales, guest counts and cash flow. Earlier this week, I had the opportunity to join our U.S. President, Chris Kempczinski, and several hundred of our U.S. Owner/Operators, who are meeting here in Chicago. We're not yet where we need to be with regaining more customer visits, and the front and center focus of the discussion was growing guest counts in our largest business segments.

Together, we're taking on a lot, and our Owner/Operators are working with our U.S. leadership team on the greatest opportunities to strengthen and grow our business. The U.S. business recently made changes to its organizational structure to better support the way we work with Owner/Operators to run great restaurants. We've removed layers from the field organization whilst increasing resources in key areas, such as technology and field consulting.

A key element of the restructuring includes providing more consulting and better support for Owner/Operators we execute together on the many initiatives of our bigger, bolder Vision 2020 U.S. plan. We expect to see improved speed to market and decision-making as the U.S. becomes fit for purpose. And that better alignment enables us to provide a great experience for our customers and unlock the full potential of the plan. This gives a high level of view what's driving our business.

And now, we'll share details of our results for the quarter. Globally, comparable sales increased by 4%, during the quarter, marking our 12th consecutive quarter of comparable sales growth. Global comparable guest counts declined slightly during the second quarter, dropping by 0.3%. Guest counts grew in all of our international operating segments, but in the U.S., quarterly guest counts decreased from a year ago.

And now, Kevin will walk you through more details about our sales and guest count performance during the quarter.

Kevin M. Ozan

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

Thanks, Steve. Our strong global comp sales performance for the quarter reflects positive results in every business segment, led by the International Lead markets in Japan. This quarter also marks the seventh consecutive quarter of positive guest count growth in all international segments.

Taking a look at the U.S., comp sales increased 2.6% for the quarter, with a positive GAAP of 90 basis points versus QSR sandwich competitors. A higher average check drove sale due to favorable product mix shifts and menu price increases. The product mix shifts were a result of several factors, including a trade-up to higher priced

items such as our fresh beef quarter pound burgers and \$1 \$2 \$3 Dollar Menu add-ons resulting in higher basket size.

An important part of our U.S. plan includes delivering a balanced mix of both higher average check and comparable guest count growth. As I just mentioned, we've seen positive benefits in average check. However, we remain intensely focused on increasing customer visits.

As we've said in the past, we must be competitive on value. We don't strive to win on value, but we won't lose either. With a sluggish IEO market and the introduction of our \$1 \$2 \$3 Dollar Menu at the beginning of the year, we've seen our competitors increase their attention on deals. Therefore, we know that we need to be more aggressive to compete effectively. While our \$1 \$2 \$3 Dollar Menu is driving incremental sales and guest counts with our budget basic value customers, we need to do more to attract other customer groups.

In addition to the delicious food that customers can get at a low price every day, we know that certain customers are looking for a great deal in the marketplace. We need to better meet the expectations of these deal customers and give them reasons to visit us more frequently.

As I mentioned earlier this year, while we will maintain our \$1 \$2 \$3 Dollar Menu as our everyday value platform, we'll also pulse in deal offers from time-to-time. For example, in second quarter, we featured the 2 for \$4 breakfast sandwiches. And beginning in early August, we'll have a 2 for \$5 Mix & Match deal with some of our iconic sandwiches that we know our customers love.

Turning to the International Lead segment, comp sales were up 4.9% for the quarter, with all markets posting positive comp sales and guest counts. The UK continues to lead the segment with high single-digit sales increases for the quarter. And continued momentum in France helped them achieve their highest-ever market share.

Comp sales for the High Growth markets increased 2.4% for the quarter, driven by both Italy and Poland's double-digit sales increases, partially offset by continuing challenges in South Korea. Our Growth Plan accelerators of digital, delivery and EOTF have been critical contributors to these markets' success. As our Experience of the Future incubator market, Poland is demonstrating what a difference it makes for customers when our restaurants successfully integrate all EOTF elements.

And across the Foundational markets, comp sales were up 6.8%. Each geographic business unit within the segment contributed positively to results, with continued strong performance in Japan leading the segment.

Now, I'll turn it back to Steve.

Stephen J. Easterbrook

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

Thanks, Kevin. The philosophy strategy is working because it's grounded in evolving our business on the customers' agenda. McDonald's customers have high expectations that we will offer them great tasting food, value for money and an experience offering enhanced convenience. As we make significant progress in each of these areas, we are continuing to see customer satisfaction scores improve in most of our larger markets.

Our UK market, for example, continues to be one of our best performers as the market achieved robust sales again during the quarter. Sales were the second highest on record in May, and April set a best-ever mark for guest counts. Many elements are coming together to drive this performance. In addition to the success of iconic

menu items such as the Big Mac, our Signature beef premium sandwiches continue to be popular with our customers in the UK.

France also found success with promoting sandwiches from the core of our menu, such as Big Macs, premium sandwiches like Le Big Tasty and the McFirst, a Petits Plaisir, which continue to provide customers delicious food at a compelling price point.

And, as I mentioned, the U.S. also made strides in improving the taste of our food. The cooked when ordered Quarter Pounders made with fresh beef are hotter and juicier. We're pleased with the high customer awareness and enthusiastic responses. Sales are up and market share gains indicate that within the large classic burger category, customers are choosing McDonald's more often.

Value is essential to what many of our customers expect from McDonald's. Kevin offered details earlier about the \$1 \$2 \$3 Dollar Menu and how we're optimizing the U.S. value platform. Our markets across the world also have value at the core of their strategies, utilizing extended always-on, compelling everyday value platforms plus rotating deals.

We are finding that the McDonald's mobile app is an increasingly effective way of extending appealing deals to our customers. We've talked previously about markets successfully using a digital activation approach that customers appreciate, with daily deals offered over several weeks or a month.

Our velocity accelerators are continuing to gain traction and contribute to our business. They represent significant opportunities to enhance the customer experience with greater convenience.

Today, I'll offer up an update about the progress we've made with the delivery accelerator, the business impact we're seeing and what we expect in the future. The delivery market continues to grow. With the power of proximity, McDonald's is well positioned to be a leader in delivery. Across the globe, there are more than 1 billion people living less than 10 minutes from a McDonald's. That gives us a significant advantage in quickly bringing delicious food to our customers in their homes, offices and college dorms.

We've been moving at a pace that is unprecedented in the McDonald's System. Last July, delivery was available in about 7,800 McDonald's restaurants around the world. We've continued expanding and now delivery is available from more than 13,000 restaurants through 60 markets on 6 continents. Customers are responding.

Delivery's becoming a meaningful contributor to our sales. And in several of our top markets, delivery now represents as much as 10% of sales in those restaurants offering delivery. Delivery requires virtually no additional investment and is tremendously effective in bringing profitable and incremental guest count. We're continuing to see delivery orders of about double the size of the standard restaurant average check.

Our biggest opportunity remains in driving awareness. When more customers learn they can get their favorite McDonald's food delivered right to their door, we're confident we'll see delivery sales continue to grow.

With McDelivery Day earlier this month, we celebrated the success of enhancing convenience to our customers with delivery. During the day, we engaged with customers around the world and saw a surge in delivery activity in the markets participating in the campaign. In the U.S., for example, we had the highest number of delivery transactions ever in a single day.

We were also able to leverage our FIFA sponsorship during the World Cup to raise awareness about delivery. A number of our markets, including Portugal and the UK, ran fun and effective promotions that reinforced the convenience of delivery.

Our strong relationship with Uber Eats is one of the reasons delivery has been so successful for our business. Over the past year, we've worked effectively with Uber Eats to optimize the delivery process. We've taken steps to protect the quality of the food as it travels from restaurants to our customers and improved operational efficiencies so orders are delivered as quickly as possible.

We're continuing to work closely with Uber Eats to elevate the customer experience and introduce marketing promotions that should stimulate even more growth. Delivery, like other elements of velocity plan is contributing to our success now and offers untapped potential for us to capture in the future. We'll look forward to sharing updates as we make additional progress.

Now, Kevin will discuss more financial highlights from the quarter.

Kevin M. Ozan

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

Thanks, Steve. Earnings per share for the quarter was \$1.90, a 9% increase in constant currencies. These results include \$92 million of strategic charges, primarily related to reorganizing our U.S. business unit, which Steve mentioned earlier.

Excluding these charges and prior year strategic charges, earnings per share was \$1.99, a 12% increase in constant currencies. Business performance from comparable sales growth offset the impact of refranchising, while the quarter also benefited from a lower tax rate.

As I talk about our operating performance, I want to remind everyone that our second quarter results are compared against results last year prior to refranchising China and Hong Kong. This was the most significant refranchising transaction in our history, which we completed last July.

As I've mentioned in the past, we measure the efficiency of our business by our operating margin and this serves as a comprehensive gauge of our overall performance. We've taken significant steps to capitalize on the strengths of our business model, achieve efficiencies with our G&A and stabilize our P&L, all of which are yielding significant benefits to our operating margin as we continue to progress towards our target of mid-40s. Year-to-date, our operating margin was 42%, up from 37% last year.

The largest and most important component of operating income is our franchise margins, as over 80% of our total restaurant margin dollars now come from our franchise business. For the quarter, every segment grew franchise margin dollars, led by the International Lead markets, while global franchise margins totaled nearly \$2.3 billion, a 9% increase in constant currencies.

Refranchising benefited the quarter, along with positive comp sales growth, partially offset by higher depreciation expense related to our EOTF partnering contributions in the U.S.

Consolidated company-operated margins declined 80 basis points to 17.9% for the quarter. That decrease was primarily driven by continued labor and commodity pressures across key markets.

Moving on to pricing and commodities, second quarter pricing in the U.S. year-over-year was up about 2%, which was below food away from home inflation of 2.8%. Commodity costs in the U.S. for the quarter were also up around 2% versus last year. For the full year, we continue to expect our U.S. grocery basket to increase 1% to 2%, as we anticipate commodity cost pressures will lessen in the fourth quarter.

For the International Lead markets, commodity costs were also up about 2% for the quarter. And we expect commodities to be up a similar percentage for the full year. ILM menu prices averaged about 2.5% higher year-over-year.

Continuing on to G&A, G&A for the second quarter increased 2% in constant currencies as a result of higher restaurant technology spending, along with costs associated with our worldwide convention in April. We continue to expect our full year G&A to decrease about 1% in constant currencies.

Our effective tax rate was 26% for the quarter. While we may have additional adjustments this year as the guidance on tax reform continues to evolve, we still expect our full year tax rate to be in the 25% to 27% range.

Finally, looking at foreign currencies, EPS benefited \$0.05 per share for the quarter due to foreign currency translation. Given the recent strengthening of the U.S. dollar and based on current exchange rates, we now anticipate FX will be a headwind of \$0.02 to \$0.04 for the third quarter, with a full year FX benefit of about \$0.07 to \$0.09. As usual, this is directional guidance only because rates will change as we move through the remainder of the year.

Now, I'll turn it back to you, Steve.

Stephen J. Easterbrook

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

The momentum in our business shows that the Velocity Growth Plan continues to gain traction. We're still in the early stages, and we're confident there is plenty of growth left in this plan. We recognize in the U.S., we're experiencing the challenge of a highly competitive environment while executing an ambitious and complex multiyear plan. We know we have a strong and an agile leadership team and committed Owner/Operators working together and moving quickly to take the right actions for our business.

While we focus on business performance, we also continue to take steps that strengthen our brand. During the quarter, we completed the transition of entirely moving our global headquarters from the suburb of Oak Brook to the heart of Chicago. We marked the occasion with a grand opening in early June, when we were able to honor current and former leaders of our company who have done so much to help build the McDonald's brand.

This move has continued to energize our teams as they experience a more open collaborative environment in our new headquarters and enjoy the dynamic neighborhoods of such a vibrant city.

Also in June, we generated brand excitement with our customers as we moved forward with the first in a series of cross-promotional campaigns in the U.S. with Disney. We featured Happy Meal boxes and toys themed with Disney's summer hit movie *Incredibles 2*.

As you can see, the broad-based success across our business illustrates the strength of our overall approach. We look forward to sharing additional progress in the months ahead. And I will hand it back to Mike and we can take some questions.

QUESTION AND ANSWER SECTION

Mike Flores

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

A

Thank you, Steve. We'll now open up the call for analyst and investor questions. [Operator Instructions] Now, the first question is from Sara Senatore with Bernstein.

Sara Harkavy Senatore

Analyst, Sanford C. Bernstein & Co. LLC

Q

Hi, thank you very much. I wanted to just ask about the emphasis on value. And I guess twofold, one is to the extent that maybe the value platforms that you had the beginning of the year weren't quite as strong as they needed to be, I guess are you confident that you've gotten ahead of that now because presumably there will be competitive response to anything new that you bring out?

And the second question related to that is the issue tension with franchisees, because, again, it seems pretty apparent that value was going to be a very competitive space. But your McOpCo margins have come under pressure. So I wasn't sure if maybe that's what has kept you from being more aggressive.

Stephen J. Easterbrook

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

A

Hi, Sara. I'll take that one. Here's what we did. As you know, at the very start of the year, we launched the \$1 \$2 \$3 Dollar Menu and that was established as our kind of everyday entry value level. And we always said it was going to take us a quarter or two to fully be able to analyze consumer response to see the dynamics across our business, whether it was from a top-line sales, whether it's from guest count and also the margin implications.

We continue to be confident that platform is resilient and is delivering what we expect it to do. However, I would say because we have been aggressive, we have seen more competitive activity in the area of value broadly. We've been able to decompose our trading performance to actually analyze the opportunity we believe we have in the area kind of meal deals. That's where the competition has been particularly strong.

So we believe that the \$1, \$2, \$3 entry level, if you've just \$1 or \$2 in your pocket, it works. If you want to add on to your meal combinations, it works, whereas the meal deal element where we think we need to be more competitive. And both Kevin and I steal from the phrase that Chris Kempczinski uses with the U.S., which is we will remain competitive on value. We're not looking to win on value. We will remain competitive.

I can tell you as recently as this week, and having spent a good deal of time with a few hundred of our leadership Owner/Operators, we were able to analyze the detail. We're able to galvanize ourselves together. I'm not going to give a whole heap of detail about it, but you can expect us to be reactive and far more agile in the way that we respond in the marketplace. And the Owner/Operators are absolutely consolidated and behind that decision because they want to grow guest counts because they know that's the ultimate lifeline of our business.

So is there work to do? Yes. Are we happy with where we're at right now? No, not entirely. Are we confident that we've got the right plans in place and the support from the entire U.S. Operator system? Entirely. So we're going to keep pushing on and competing hard.

Mike Flores

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

Next question is from Andrew Charles with Cowen.

Andrew Charles

Analyst, Cowen and Company, LLC

Great, thanks. You called out 90 basis points outperformance versus quick service peers versus a roughly, call it, 200 to 400 basis points level you had been running over the last five quarters. And so, you kind of touched on it a little bit with the meal deals, but what do you attribute to a narrowing of outperformance versus quick service peers as Q2 did offer compelling value between \$1 \$2 \$3 and the two for \$4 breakfast sandwiches?

Stephen J. Easterbrook

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

I would say we're taking share on a sales point of view, but we're not taking share on the guest count. So I mean, it still comes down to driving the guest count. So yes, we put some activity in the marketplace. What we are looking to do, I mean, there's a number of initiatives that we have agreed upon across our U.S. business. So, for example, when you look at our breakfast performance overall, that's an important part of our overall sales mix, as you know, and it's been a stronghold for us for many, many years. But we've just begun to lose a little bit of share at that daypart, in particular.

And, as we've also explained in the past, we have changed our approach to how we market across the U.S. We moved a little bit more out of the local marketing dollars into the national marketing. We believe, for example, that for getting the breakfast share back, that's more of a local market activity. The tastes and wants of consumers around the U.S. are pretty vastly different at that breakfast daypart. Some are: coffee-led markets that are food supported; others, food-led markets that are beverage supported. So we believe putting the power back into the local co-ops is the right way to go.

So, yeah, there's multiple facets to it. We have taken share on the sales level for 72 of the last 78 weeks in the U.S. and that's a trend we expect to continue. We want to get the traffic share back as well. So we want to be greedy. We plan to be greedy and win on both sales and guest count and that's where we're galvanizing ourselves around.

Mike Flores

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

The next question will be from Jeff Bernstein with Barclays.

Jeffrey Bernstein

Analyst, Barclays Capital, Inc.

Great, thank you very much. Just touching on the company-operated and, I guess, maybe more importantly, the franchise profitability, I think you said all constituents are behind you in terms of being more nimble. But with the continued pressure on labor and, I guess, to a lesser degree, food costs, it seems like you want to keep pricing below food away from home. But do you think the franchisees are okay with the near-term margin pressure or do you think maybe that this inflationary environment is unusual and, therefore, justifying a further bump in the pricing, whether or not that's on premium or still keeping the value? I'm just trying to gauge the franchisee sensitivity to this aggressive value push and their profitability.

Stephen J. Easterbrook

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

A

Well, Kevin, can certainly follow up. I'll have the first stab at this one. There are multiple dimensions to what grows, obviously, cash flow. And, at the moment, the average check growth is strong. Not a lot of that's coming through pricing. A lot of it's coming through mix. With the increasing take-up of customers take-up self-order kiosks, we get a higher average check there. As we continue to roll out delivery, we get twice the average check there.

So I'm not so concerned about the average check increases as long as it's not being too forceful through just price itself, because the consumer is still sensitive out there. People are a little tentative. They're a little cautious and you got to stay in line.

We are very transparent with our Owner/Operators. We engage with them day-to-day, week-to-week, month-to-month. And we share with them exactly what they can expect from food costs and commodity increases, and what we can expect from utility increase, what we can expect from new product margins. I mean, would we all like to grow income? Well, of course.

Are they still entirely unified behind the plan we have and believe in its long-term strength? Absolutely, right. And there's nothing we want to do more than grow operator cash flow, because that's such a great motivator for future investment and future confidence. So in the immediate term, they are pragmatic, but we certainly have a desire to be growing, not just our own income and margins, but also their cash flows as well.

Mike Flores

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

A

Next up is Brian Bittner with Oppenheimer.

Brian Bittner

Analyst, Oppenheimer & Co., Inc.

Q

Just following up on the conversation, you kind of keep saying this thing on value, that you don't want to win on value, you just want to be competitive, but I think, arguably, a large reason why sales trends have been so solid for extended periods is because you've been winning on value.

So I guess the main question is, why not have a strategy to continue to win on value? Is it because of the margin structure of value and the headwind it presents for franchisee profits? Or is there some other reason why you don't want to necessarily win on value moving forward?

Stephen J. Easterbrook

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

A

Well, I'd slightly dispute the fact that the sales growth has come from winning on value. I think it's been multidimensional. I think, yeah, we're selling more premium products at the top-end of the menu with the Signature Crafted.

When you have a investment in a restaurant, we see the pickup in sales from the EOTF conversions, which are still delivering what we have seen elsewhere in the world. When it's a full modernization EOTF here in the U.S, we're getting mid-single digit sales uplifts. When it's just adding the EOTF elements on modernized restaurant, we're still getting 1% to 2% uplift. So I think there's multiple levers at play that are driving the top line.

And the reality is, we are looking to build a moat around the business. And the more we invest in food quality, the more we invest in our employment proposition and enhance services, the better the technology relationships we have with our customers, the more modernized our restaurants become, the harder it will be for people to compete with us. And therefore, we're not intending to lead any race to the bottom here. We just want to be competitive on value. And I retain that and we stand behind that.

Mike Flores

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

Next caller is David Tarantino from Baird.

David E. Tarantino

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

Hi. Good morning. A couple questions about the U.S. comps, so, first, could you talk about how the launch of fresh beef did relative to your expectations prior to that launch? And then secondly, I was wondering if there were factors outside of this value discussion that might have hurt the comps in Q2. And specifically, lower throughput following the launch of fresh beef, given the operational change there or disruption from the remodeling activity, if you could just comment on those last few factors as well. Thank you.

Stephen J. Easterbrook

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

Yeah. Again, I'll try and address these as best I can, David. So, fresh beef has been a significant operational rollout for us. Let's, first of all, just recognize what we're doing here. Really it is a material change to the operating system on our largest beef patty. And the great news is because the buzz became so strong, the awareness levels at launch were around 80%, which is kind of way on the top end of any sort of promotional or launch activity you can normally expect. Consumer sentiment has been really high. And we believe we're taking share in that sort of bigger burger sort of category.

That said, it has been a slight operational complication to us. It's added a few seconds to service time. The teams are on to that. I mean, first of all, there's familiarity in a restaurant, which will help bring that down. But also, we're looking at other things we can do to simplify the operation to help bring our service times down. So I think there's a marginal increase, particularly in the drive-thru. It's less of an issue in store. It's almost mainly through the drive-thru. And our teams are looking to address that. Go on, Kevin.

Kevin M. Ozan

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

I'll take a little discussion on EOTF downtime that you mentioned, David. I guess, just to give a perspective, EOTF downtime, obviously, depends on exactly what we're doing in any particular restaurant. But roughly, a week, five to 10 days or so, would be kind of normal downtime. But you also have to think about there's a little bit of an impact on what I'll call collar days, kind of right before and right after that. So that you actually get a little bit more impact than just the days it's down.

Now, that does have an impact on current quarter comp sales, guest counts and margins, because, as you would expect, labor becomes a little bit less efficient when you have a week of downtime. So those stores that go down do have some near-term impacts. I think it may be a little bit more than we even thought, I think as we're getting into some of the projects we want to make sure we're doing all the right things and getting in once and getting it done right.

We feel pretty good about when they come out of that downtime, though, when they reopen, what we're seeing is the markets or the restaurants increase sales similar to what we've seen internationally, which is the mid-single digit sales for people who do a full remodel and, obviously, less than that for people who just add the EOTF elements.

Stephen J. Easterbrook

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

A

Just to add to that as well. I mean, yeah, we're a large business and sometimes our numbers can be in millions and billions. And kind of, we just get used to that. I want to put in context, we converted 1,300 restaurants in 90 days. And that means across that quarter, 14 or 15 communities are waking up every day to a dramatically modernized restaurant and a much better experience.

So is there a little drag through this conversion period? Yes, there is but I wouldn't swap it for anything because the upside for the long-term, actually the medium, but also the longer term, is so evident to us, as is evidenced by the performance out of Canada, out of UK, out of France, out of Germany, out of Italy, out of Spain, out of Poland. We know these are sales kickers and sustaining sales growth. So we'll take a little short-term bit of pressure on that, but we're unflinching in our desire to modernize the estate here in the U.S. And I'm proud of the team because 1,300 restaurants in a quarter is quite remarkable.

Mike Flores

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

A

Our next question is from Karen Holthouse with Goldman Sachs.

Karen Holthouse

Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thanks for taking the question. Another one on U.S. store margins, in prior quarters, you've talked about some pretty explicit almost one-time investments in training and getting the stores ready for a lot of the initiatives that are in the pipeline. Could you give us a little bit of color for what that sort of investment or what that sort of pressure in the quarter could have looked like?

Kevin M. Ozan

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

A

Yeah, thanks, Karen. I think that pressure is dissipating. We now have fresh beef in all of the locations. So certainly, you would have seen for the first half of the year for several months of the year, some training and investment as we were kind of ramping up to get fresh beef in everywhere. I'd say that's starting to dissipate.

Now, we will still see it here and there as we do EOTF restaurants, because once a restaurant goes through EOTF, it generally takes a little bit of time to settle back in kind of normal because it is a change for the restaurant also. So we'll see some of that continue as we convert EOTF. But I'd say overall, the overall investment, if you will, is starting to dissipate from where it was at the end of last year, beginning of this year.

From an overall margin side, I'd say labor costs continue to be a pressure. Commodities this quarter were still a little bit of a pressure. And that EOTF downtime, as well as depreciation, will be another pressure in the near-term as we go through these EOTF projects.

Mike Flores

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

A

Next question is from Nicole Miller Regan with Piper Jaffray.

Nicole Miller Regan

Analyst, Piper Jaffray & Co.

Q

Thank you. Good morning. You've talked about this gap, right, of either in the U.S., who's done it early, or the international markets that have done Experience of the Future or value delivery, et cetera. And it's at the higher comp than what the U.S. comp is. So how important is the field management streamlining and change and support you can offer the franchisees in closing that gap and capitalizing on these opportunities?

Stephen J. Easterbrook

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

A

So that's a great question. I'll take that. I mean, the reality is building a strong aggressive multidimensional plan is one thing. Executing it is everything. So what Chris and the team have done is taken a look at how can we best reallocate our resources to where it's needed most. And we are now in execution mode. And I tried to paint that picture a little bit last quarter and you can expect me to continue paint it probably the next six or seven quarters, in all honestly. We're in execution mode.

Now, we will finesse the plan a little bit along the way. We'll be agile. But fundamentally, we know have the right drivers in the right place. And what we want to do is best support the Owner/Operators and help them execute to the highest level. And I typically said I will take an 80% quality plan executed 100% every time over a perfect plan that's executed 80%. Because ultimately, it's the customer experience that really, really matters.

So the reorganization and the reallocation of resources to help get stability and consistency into our technology platforms to make it easier to run the restaurants, and also just provide that consulting support. We've got project management offices set up. We've got what we call tiger teams that will go and find the little hotspots anywhere and just help with the execution. Actually, it's the boots on the ground, experienced field consultants who can help support and guide the Owner/Operators through this quite a significant transitional phase that we're going through. That's the whole purpose of it. And I'm confident that it's really going to be well received by the Operators and they're excited to receive more support.

Mike Flores

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

A

Next question is from Will Slabaugh of Stephens.

Will Slabaugh

Analyst, Stephens Inc.

Q

Yeah, thank you. I had a question on the International Lead markets and other growth markets as we could maybe translate those to what's happening in the U.S. or what may happen in the U.S. Can you talk about the evolution of average check and guest counts that you've seen over time as you've undergone modernization and various value initiatives in those international markets and now, obviously, we're seeing some benefits of those? How should we translate that success to what we're seeing in the U.S. and maybe what potentially we will see?

Stephen J. Easterbrook

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

A

Well I think it does differ by market because the competitive environment differs by market. But if I was to take a broad swipe at that, I would say historically, what we've tended to see and, again, this is a generalization. With

sales growth, typically around half of that over time has come from guest count growth and about half from average check. And the majority of the average check growth has typically come from pricing.

What I do tend to see now in the International Lead markets is, yes, there's absolute guest count growth. Actually, the average check growth is a little higher, but not because of pricing. People will price in line with the market, in line with food away from home, in line with the competitive environment. But once you get those platforms in place, you tend to be able to leverage more at the premium end of your menu.

As I mentioned before, the more customers that choose to order through the self-order kiosks tend to dwell a little longer and spend a little more because the average check's higher there.

And as we roll out initiatives such as delivery, we're getting an average check kicker there as well. So I think what we'll tend to see is we still want that guest count growth. It wouldn't surprise me if the average check growth becomes a little more significant than the guest count growth, but we just absolutely not want to do that through price. It's really through leveraging the investments we've made. And once you get that quality base in place, that gives you a lot of opportunity to get your mix right, your basket size right and customers tend to do a little more and spend a little more.

Mike Flores

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

A

Next question is from Alton Stump with Longbow.

Alton K. Stump

Analyst, Longbow Research LLC

Q

Thank you and good morning. Back to your comment about the breakfast [indiscernible] first half of the year, outside two for \$4, both your platforms, \$1 \$2 \$3, of course, fresh beef were certainly an indicator focused on, of course, the lunch and the dinner dayparts, So I think by your comments I understand the fact that a lot of it should be local marketing. But is there an opportunity from a national perspective to put more focus behind your breakfast offerings during the back half of the year?

Kevin M. Ozan

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

A

Yeah, I can take that or start that, Alton. We talked about breakfast has been a little bit of an opportunity for us for a little while. I think one of the things that happened was breakfast was really carried locally, primarily last year. And we kind of had an abrupt change at the end of the year where we really moved almost all of it to national. And so I think what we've been spending the last several months is just make sure we have the right balance. You will see there's obviously breakfast products on \$1 \$2 \$3 Dollar Menu. As we've talked about, we will likely tweak \$1 \$2 \$3 Dollar Menu as we go through the year, so you could see little changes. So there will be a big piece of breakfast that is included in the national platform, the \$1 \$2 \$3.

But in addition to that, we need to make sure that we carry some important breakfast messages locally, because there is a difference, certainly maybe even more so in breakfast than other dayparts, places like the South that really like biscuits. It's going to be very different than the Northeast or Northwest. And so, we just need to make sure we've got in the night national value platform related to breakfast as well as the right local messages that can resonate with the individual local customers in each place.

The only other thing I'd say is breakfast guest counts remain negative. So we still got an opportunity for that. We did have positive comp sales in breakfast in the second quarter. So we have seen at least a little bit of the trend start improving. We still have a lot more way to go. But we did see breakfast comp sales finally positive in the second quarter.

Stephen J. Easterbrook

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

A

Well, I think you can also probably at a national level, expect to see us continue to invest and support the McCafé brand more broadly. I think that has national – a universally supported nationally across the U.S. with our stripped coffee or the more premium coffees now with the investments we've made in quality equipment. So, I think that one lends itself to national, but certainly food-led breakfast in particular, we think is a more localized support, as Kevin has already have mentioned.

Mike Flores

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

A

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

Gregory R. Francfort

Analyst, Bank of America Merrill Lynch

Q

Hey, guys. I just have a housekeeping one and then another question. Just on the 4,000 remodels you're doing this year, how many of those are full versus partial? And then, of the ones you're going to have left after this year, how many of those are going to be full versus partial remodels?

And then, my other question is just, Steve, you talked about the average check being driven more by mix. Is that a conscious decision you're making to take the brand a little more upscale over time or is that sort of not how you're thinking about it?

Kevin M. Ozan

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

A

I'll take the first one.

Stephen J. Easterbrook

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

A

Okay.

Kevin M. Ozan

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

A

The question about how many are modernized versus non-modernized or full versus partial, as you called it, I'd say this year should be relatively representative. It's about a third of what you'll call full are the complete and then about two-thirds of partial or where you just need the EOTF elements. We will probably and we're a little more skewed to McOpCo probably this year, so about half of our McOpCo estate or company-operated, are complete at this point. So it may be a little bit more front-loaded on the company-operated sites. But in general, it should be similar between the about a third full and about two-thirds partial this year and going forward.

Stephen J. Easterbrook

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

A

With the second half, no, I wouldn't describe it as a conscious effort to take the brand up-market. I mean we don't want to alienate anyone. And we will always stand for value. But as we continue to invest in the brand, as you invest in quality and the properness of our food, you invest in the physical real estate, as you invest in technology, what you tend to do is broaden your customer base.

So I think really what we end up doing is appealing to a broader range of customers on more occasions, more often. That's what it's all about. We want to do the things that positively impact the most people in the most areas as possible, but I wouldn't say it's a conscious effort to take the brand up-market. Continuing to reinvest in the brand and keep it relevant for customers today is what it's all about. And it's a competitive marketplace. We want to differentiate ourselves from the competition and we believe we have some initiatives in place that will help broaden the gap between us and the others.

Mike Flores

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

The next question is from Matt DiFrisco with Guggenheim.

Matthew DiFrisco

Analyst, Guggenheim Securities LLC

Thank you. I just have a follow-up on that and then also just want to know about – I know you don't like to talk about current trends, but there's been some news about these salads and things like that. I was just curious how that might have been resolved, impacted or how that might manifest itself in trends. But you also just mentioned about alienating a customer. Obviously, I don't think you purposely would want to ever chase away people. But could you sort of narrow down the drag that was referred to from the conversion? Is that manifesting itself in less frequency, you think, from your customers, or could you narrow that down to a specific cohort maybe of that lower income demographic that perhaps the value message has been a little bit diluted as you've been elevating the brand? And they could come back or have you just seen simply less frequency from your existing customers?

Stephen J. Easterbrook

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

I'll take the salad one. Yes, I mean, obviously, I mean, food safety and the customer's well being is our absolute number one priority, first and foremost. So, as you know, we've been contacted by the public health authorities from Iowa and Illinois about certain infections across produce in those states. We have removed existing lettuce blend from the identified restaurants. It impacted around 3,000 restaurants, but as of July 23, so when was that? That's three days ago. All those restaurants have been fully replenished with a new supply and we continue to trade fully. So I wouldn't say that has a material impact on our trading performance. It's something you don't want to be associated with, so we take it very seriously. But from a trading perspective, it really hasn't been something that is particularly material.

Kevin M. Ozan

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

I'll take the second one. I tried talking in my script a little bit about kind of these two different customer groups. There is one customer group that we call, or that are called, budget basics, that are really looking for kind of everyday predictable low prices. And our \$1 \$2 \$3 Dollar Menu has been successfully dealing or addressing those customers. Where we've had a little bit of gap, if you will, is these deal customers, who are people that love fast food, but they will go to several different outlets based on who's got the best deal or who has a really compelling deal. And I think that's the area where we haven't been as competitive as we've needed to be because some of our competition has stepped up on their deal side.

And so we've talked about we need to make sure on the deal side that we're competitive so that those customers are – that's where we would have lost, I'll say, some frequency of customers, as you talked about. So it's really just having those customers come back to us more frequently because we've got the compelling deals on a regular basis.

Mike Flores

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

A

Next question is from John Glass with Morgan Stanley.

John Glass

Analyst, Morgan Stanley & Co. LLC

Q

Thanks very much. Two on comps, first, just on the global comp or the global traffic, it declined for the first time in several quarters. And I know you called out the U.S, but I'm assuming U.S. is somewhat similar, at least on a comp basis, versus last quarter. So are there other international markets where traffic is still positive but maybe has decelerated worth calling out? I know you said South Korea. But are there other places that you're starting to see some traffic deceleration that would account for that global deceleration in traffic?

And earlier this year, I think you reduced the advertising spend in the U.S. as part of the rollout of the \$1 \$2 \$3 Menu. Do you think that's at all a root cause of perhaps some of the weaknesses or said another way, is there a need to reinvest in some advertising dollars in the U.S. as a way to drive traffic?

Stephen J. Easterbrook

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

A

I'd say from a guest count perspective, I mean, clearly the U.S. has come to be our largest market. And therefore, if that goes weak or goes negative, that tends to drag things down. Other somewhat more noticeable trends over the last, I would say, three months to six months have been China, where we're still getting like-for-like sales growth, but the guest count growth has gone negative in China through the quarter. The impact within that market on the uncertainty of the trade discussions has – I mean, clearly, it's hit the markets, which, in turn, hits consumer confidence. And so, we're keeping close to that and adjusting our plans, so we can be competitive there.

And Russia continues to be hard work for us. So we're getting negative guest counts there at the moment and now we're making some changes with our team there, but also with our strategy there. So we can compete slightly more fully.

On the advertising side, you're right. We reduced the contribution here in the U.S. for both Owner/Operators and the company. I don't think our issue is around the percentage contribution. I think what it takes is a little bit of time, that when you move from 180 co-ops down to 56 co-ops, when you move from 44 local marketing agencies to a roster of five local marketing agencies, there's just a transition time for it to settle down.

So are we running at peak performance year-to-date in terms of just the effectiveness and efficiency of our marketing? Probably not. Do we believe we have the structure in place where the contribution we make now, we believe should be certainly sufficient from a share of voice for internal marketing spend and, therefore, basically be more effective and more efficient? So there's no plans to change the marketing contribution. It's just what we do with it, which is most important.

Mike Flores

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

Next question is from John Ivankoe with JPMorgan.

A

John William Ivankoe

Analyst, JPMorgan Securities LLC

Hi. Thank you. I know you don't comment or maybe can't control, I should say, staffing levels for franchisees in the U.S. or what franchisees pay their labor, but I just want to have a sense of the overall staffing environment that the franchisees are facing on a market-by-market basis and if you think the current labor market in any way is affecting some of your execution levels that maybe you alluded to in terms of fresh beef being a little bit slower through the drive-thru or any other factors in terms of processing peak hour transactions.

Q

Kevin M. Ozan

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

Yeah, John, it's Kevin. That's a good and fair question. I'd say labor staffing, it's a tight labor market out there. I think it's fair to say. And so, labor staffing is a challenge, both for us and the franchisees. But that's the industry. So I don't know that we have it any worse than anybody else. And I don't know that we can or should or do use that an excuse. I do think it is a tough labor market right now to make sure you've got the right staffing levels. And maybe because we're going through EOTF and all these other things right now, that you see a little bit of impact of that. But long term, we have to figure out that equation.

A

We've got to be able to figure out how to be efficient with our labor and be able to operate effectively. Near term, I think it's a fair point. You know unemployment is obviously very low. And so, certainly, depending on state-by-state or area-by-area, it does have an impact. So we're trying to do everything we can to invest in our employees, to invest in training to make sure that we can attract the right labor force. But it's a challenge right now in the industry, I think.

Stephen J. Easterbrook

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

I think part of what we're doing because there is a fight for talent and it's not just the U.S., actually. It's in a lot of our mature markets, partly because there is less mobile labor. Let me put it that way. So there's less migration across Europe. With the impacts of Brexit, means there been an exodus of, if you like, service sector workers out of the UK.

A

We can begin to see that impact here in the U.S. So we've got to fight that little bit harder to first of all, gain the talent and then retain it. So that's why we committed \$150 million over the next five years to Archways to Opportunity, for example. We're actually providing education and training opportunities and career development and personal development opportunity to our people. So whatever we can do to try and differentiate ourselves from others in the service sector is really important to us right now. So we're doubling-down on, if you like, the added value that we can offer our employees as well as the day-to-day hour-to-hour work.

Mike Flores

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

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

A

Chris O'Cull

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thank you. Good morning. Kevin, it sounded like from your comments that the D \$1 \$2 \$3 Value Menu may evolve to include some regional variation. I wanted to see if that was true. And then, also, is the plan to design local meal deals to be more competitive in lower cost markets where you see competition priced to that local market rather than a national level?

Kevin M. Ozan

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

A

Yeah, Chris. Let me try a couple of things there. D \$1 \$2 \$3, it's a national platform. There are and will be some options, if you will, that local markets, depending on where they are, can draw down and put on the \$1 \$2 \$3 Menu. So you will see some items that are on in certain markets, depending on where they're located. So the general platform is national. There will be certain products that will be on nationally. But locally, people will have an option of, I'll say, either adding or swapping out a couple products, here and there.

Stephen J. Easterbrook

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

A

Deal.

Kevin M. Ozan

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

A

The second part about deal, most of the deals will likely be national deals, so things like the two for \$4 breakfast that we had. The two for \$5 sandwich that we're going to have starting August and other deal platforms that we are anticipating, will generally be national platforms. So I think most of the deal will be at a national level.

Mike Flores

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

A

Okay. We've got time for one more question and that will be Matt McGinley with Evercore

Matthew Robert McGinley

Analyst, Evercore Group LLC

Q

Thank you. My question is on the International Lead and looking at the level of comp you've had over the past handful of quarters and then looking at not a whole lot of margin flow through. Given your farther along with EOTF, and I don't think the investment levels are the same there, but I believe delivery is becoming a bigger part of the mix there. I'm curious if that could be having a bigger drag on the comp than perhaps other initiatives or other investments that you're making. And if that sort of spend continues, do you think that that same level of overall rule of thumb in terms of the comp growth would have the same level of impact on the earnings on a go-forward basis?

Kevin M. Ozan

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

A

Yeah, Matt, I'll take that. I'd say we're really pleased with the comp growth that we've been getting in the International Lead markets because it's been pretty broad based. You see all five of the main markets in that International Lead segment doing pretty well. They're all in pretty good shape with Experience of the Future. Some of them, Germany and France, probably have a little bit ways to go, but the restaurants look really good. We're getting sales.

In general, those markets, I guess from our perspective, we're throwing up franchise margins of 81% and McOpCo margins this quarter of over 21%. So I think, in general, we're pretty pleased with the level of margin.

Now you do see a little bit of percentage hurt, I'll say, because of delivery, to your point. As delivery percentages and sales grow, the percentage margin on those is a little lower percentage because you've got commission to pay. But I'll certainly take the additional dollars we're getting from those sales to give up a little of that percentage. So I think we're pretty pleased with the margin flow through in those International Lead segment.

Stephen J. Easterbrook

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

A

All I'd say on some of that is we're taking share in each one of those markets as well. So, yes, we want it to carry to the bottom-line. But from a competitive position perspective, we just got stronger and stronger compared to the rest. So it's the share gains, we know, are the long-term winner for us. But they are returning pretty good profitability and some great top-line and solid guest count growth as well.

Mike Flores

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

So that completes our call. Thank you, everyone. Have a great day.

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

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