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Fitch Downgrades McDonald's IDR to 'BBB'; Outlook Stable

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CHICAGO--(BUSINESS WIRE)--Fitch Ratings has downgraded the Long-Term Issuer Default Rating (IDR) of McDonald's Corporation (NYSE: MCD) to 'BBB' from 'BBB+'. The Short-Term IDR has been affirmed at 'F2'. The Rating Outlook is Stable. McDonald's has approximately $26 billion of total debt.

The downgrade reflects Fitch's expectation that total adjusted debt/EBITDAR will be sustained in the mid-to-high 3.0x range through 2018, with EBITDA stabilizing around the current level. LTM EBITDA at Sept. 30, 2016 was $9.4 billion. Given McDonald's aggressive financial strategy, debt reduction is not anticipated.

Furthermore, while U.S. comps have improved since the fall of 2015, due in part to better store-level execution and the launch of All-Day Breakfast, Fitch does not view recent performance as sustainable. According to Bloomberg data provided by Euromonitor International, McDonald's has gradually lost share to improving quick-service competitors and fast-casual operators in the U.S. limited service restaurant industry since 2012. Fitch believes McDonald's will continue to lose share over the medium term, although quarterly volatility in share trends is anticipated, due to heightened competition and changing consumer preferences.

KEY RATING DRIVERS

Leverage Expected to Remain Elevated

McDonald's debt balance increased to $26 billion at Sept. 30, 2016 from roughly $15 billion at the end of 2014 due to the company's three-year $30 billion shareholder cash return plan which is expected to be completed by the end of 2016. For the LTM period ended Sept. 30, 2016, total adjusted debt/EBITDAR was approximately 3.6x. Fitch projects leverage in the mid-to-high 3.0x range with EBITDA stabilizing around $9.4 billion through 2018. Free cash flow (FCF; defined as cash flow from operations less capex less dividends) is projected to approximate $1 billion annually through 2018 and is expected to be deployed towards share repurchases.

U.S. Trends Soften, Share Losses Expected to Continue

The U.S. represented 39% of McDonald's 36,525 restaurants, 34% of its $25.4 billion of revenue and 51% of its $7.1 billion of operating income in 2015. Fitch is concerned about McDonald's share trends in the U.S. given softening performance and the recent narrowing of the company's comp gap versus the broader U.S. quick-service restaurant sandwich category. For the quarter ended Sept. 30, 2016, U.S. comps rose 1.3% as 3.5% pricing offset negative guest counts. Per McDonald's, its comp gap to the category narrowed to 0.6% last quarter from 2.9% in the fourth quarter of 2015. Fitch anticipates the positive September quarter comp gap was due to pricing, which according to McDonald's exceeded the industry by about 1%.

Fitch attributes McDonald's softening U.S. comps to higher pricing that led to declines in guest counts, a recent slowdown in the broader industry, heightened competition, and growing consumer preference for freshly prepared food at a good value. McDonald's typically increases prices in line with food-away-from inflation but the company's price increases have exceeded the industry over the past three quarters. Given that value continues to drive traffic and the need for operators to remain competitively priced, Fitch anticipates that McDonald's will price more in line with the market in 2017. The USDA is forecasting food-away-from-home inflation of 2% - 3% in 2017, versus 2.5% - 3.5% this year.

McDonald's is responding to changing consumer preferences by emphasizing food quality. The company is also emphasizing value with its McPick2 platform and investing in the McDonald's Experience of the Future to enhance the customer experience. However , Fitch believes McDonald's will continue to gradually lose share over the medium term in the U.S. due to increased choices for consumers, stemming from the growth of specialty burger shops like Shake Shack and Five Guys, and some weakening in McDonald's brand perception within the hamburger category and among younger and health-conscious consumers in recent years.

International Comp T rends Providing Offset

Comp trends in McDonald's international markets have exceeded those in the U.S. During the quarter ended Sept. 30, 2016, comps in the company's foundational, international lead, and high-growth markets rose 10.1%, 3.3%, and 1.5%, respectively. Strong performance in the U.K, Australia, and Canada, a recovery in Japan and China following supplier food safety issues in 2014, and locally-relevant value of ferings contributed to this growth. Fitch projects McDonald's global comps will decelerate to around 2% in 2017 and 2018, after rising a projected 3.5% in 2016. International markets are expected to continue to outperform the U.S. where Fitch expects less pricing and potentially weaker guest count trends.

Refranchising and Potential Asset Sale

McDonald's is on track with its goal of increasing its mix of franchised units from 81% in 2014 to 93% by the end of 2018 and 95% longer-term. Since the start of 2015, the company has refranchised nearly 1,000 of the 4,000 company-operated units targeted. Moreover , McDonald's recently disclosed that it is actively pursuing a transaction in China and is making progress in its search for strategic partners in Malaysia and Singapore. McDonald's operated roughly 2,200 units in China and nearly 400 in Malaysia and Singapore combined in 2015.

McDonald's shift towards a higher mix of franchised units is consistent with industry trends. In 2015, 35% or $8.9 billion of McDonald's $25.4 billion of revenue was from franchising. The margin from franchising was 81.5% versus a margin of 15.2% from operating restaurants. Fitch projects more than 50% of McDonald's revenue will be from franchising by 2018, which will increase stability of cash flow due to a steady stream of royalty and rental income.

McDonald's is also exploring the sale of a portion of its 50% ownership in McDonald's Holdings Co. Ltd (McDonald's Japan) which operated 2,956 units at the end of 2015 under an af filiate structure. Based on the entity's approximately 400 billion Japanese Y en ($3.8 billion) market capitalization, McDonald's stake is worth nearly $2 billion. Fitch anticipates cash proceeds from this transaction and refranchising could total over $4 billion and will be returned to shareholders.

G&A Cost Reductions to Continue Through 2017

McDonald's is targeting $500 million of annualized G&A cost reductions with the vast majority being realized by the end of 2017. The goal represents nearly 20% of McDonald's $2.6 billion expense base at the beginning of 2015. Savings will be realized through refranchising, lower corporate overhead, and greater ef ficiencies across global business services. The company expects to realize $150 million of savings, excluding increased incentive compensation, by the end of 2016. Fitch expects these savings along with increased franchise royalty and rental-based income to of fset operating income declines associated with refranchising.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for McDonald's include:

--Revenue approximates $24.7 billion in 2016 and declines to below $20 billion by 2018 due to refranchising;

--Global SSS growth approximates 3.5% in 2016 and 2% in 2017 and 2018 due to 2% - 3% pricing and flat to slightly negative guest counts;

--Operating income grows 7% to $8 billion in 2016, is relatively flat through 2018 due to G&A cost reductions and expense management;

--Total debt is sustained around $26 billion through 2018;

--FCF approximates $1 billion annually in 2017 and 2018;

--Total adjusted debt-to-operating EBITDAR is in the mid-to-high 3x range through 2018.

RATING SENSITIVITIES

Future developments that may , individually or collectively, lead to a positive rating action include:

--Total adjusted debt-to-operating EBITDAR sustained in the low-3x range;

--Global comps consistently above 2% along with the maintenance of market share in the U.S.

Future developments that may , individually or collectively, lead to a negative rating action include:

--Total adjusted debt-to-operating EBITDAR near 4x due to material declines in operating income or increased debt;

--A year or more of negative global comps and greater than expected loss of market share in the U.S.

LIQUIDITY

McDonald's liquidity is supported by its FCF , cash balance, and a $2.5 billion revolving credit facility that expires December 2019. As of Sept. 30, 2016, liquidity totalled $4.8 billion and consisted of $2.3 billion of cash and $2.5 billion revolver availability. Debt maturities are estimated at $1.6 billion in 2017, $1.8 billion in 2018, and $1.5 billion in 2019. Fitch expects maturities to be refinanced, as debt paydown is not anticipated.

FULL LIST OF RATING ACTIONS

Fitch has downgraded the following ratings:

--Long-Term IDR to 'BBB' from 'BBB+';

--Bank credit facilities to 'BBB' from 'BBB+';

--Senior unsecured debt to 'BBB' from 'BBB+'.

The following ratings have been af firmed:

--Short-Term IDR at 'F2';

--Commercial paper at 'F2'.

The Rating Outlook is Stable.

Summary of Financial Statement Adjustments - Financial statement adjustments that depart materially from those contained in the published financial statements of the relevant rated entity or obligor are disclosed below .

-Historical and projected EBITDA are adjusted for material one-time items as reported in financials.

--Fitch views operating leases as debt-like obligations, so capitalizes gross rent expense using a multiple of 8x.

Additional information is available on www.fitchratings.com .

Applicable Criteria

Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016)

https://www.fitchratings.com/site/re/885629

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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