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Q2 2020 Yum China Holdings Inc Earnings Call

EVENT DATE/TIME: JULY 30, 2020 / 12:00AM GMT

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Yum China 2020 Second Quarter Earnings Conference Call. (Operator Instructions)

But I will now hand the conference over to your first speaker today. Thank you, and please go ahead, Debbie.

Debbie Ding ***Yum China Holdings, Inc. - Senior IR Manager***

Thank you, operator. Hello, everyone, and thank you for joining Yum China's Second Quarter 2020 Earnings Conference Call. Joining us on today's call are our CEO, Ms. Joey Wat; and our CFO, Mr. Andy Yeung.

Before we get started, I'd like to remind you that our earnings call and investor presentation contains forward-looking statements, which are subject to future events and uncertainties. Our results may differ materially from these forward-looking statements. All forward-looking statements should be considered in conjunction with the cautionary statement in our earnings release and the risk factors included in our filings with the SEC.

This call also includes certain non-GAAP financial measures. You should carefully consider the comparable GAAP measures. Reconciliation of the non-GAAP and GAAP measure is included in our earnings release.

Today's call includes 3 sections. First, Joey will provide an update regarding recent developments, then she will offer some highlights around the quarterly results. Andy will then cover the financial results and provide an update on our full year outlook. Finally, we will open the call to questions.

You can find the webcast of this call and a PowerPoint presentation, which contains operational and financial information for the quarter on our IR website.

Now I would like to turn the call over to Ms. Joey Wat, CEO of Yum China. Joey?

Joey Wat ***Yum China Holdings, Inc. - CEO & Director***

Thank you, Debbie. Hello, everyone, and thank you for joining us today. I will first update you on COVID developments, and then we'll move on to cover performance in more detail.

Throughout the COVID pandemic, we have been committed to safely providing good food, great value and convenience for our customers wherever they are. Safety is the key word here. In our stores, temperature checks, face masks and frequent disinfection and cleaning protocols remain in place.

A safe and healthy environment creates confidence for our customers and employees, which helps drive recovery in our business. We approach this challenge with an open mind, with flexibility, speed and the courage to try new things. Our nimble marketing, enabled by our digital infrastructure, helped drive improvements at both of our core brands compared to the first quarter. KFC launched Buy 1 Get 1 Weekends in June for the first time for members. Pizza Hut drove traffic with its first-ever all-you-can-eat promotion, featuring steak and baked crayfish.

We focused our resources on engaging with our members, targeting specific offers and promotions. Our Privilege programs drive frequency, spend and cross-sells. However, we are still experiencing significant headwinds. The recovery path is nonlinear and uneven. April and May sales improved sequentially, while June was impacted by delayed school holidays and more stringent social distancing due to resurging regional infection. Our transportation and tourist locations continue to experience significant year-on-year volume declines, which impacts KFC more than Pizza Hut. Around 60 of our stores in Wuhan and Northern China remain closed for the time being.

Even with short-term uncertainty, we are enthusiastic about long-term prospects. In an incredibly challenging environment, we celebrate 3 important achievements. First, we opened our 10,000th store in July. This is truly an incredible achievement that would not have been possible without our exceptional [efforts of] (added by company after the call) employees. We are seizing this opportunity to expand our footprint.

Second, Pizza Hut has now been serving our Chinese consumers for 30 years. Beginning in June, we kicked off our 30th anniversary celebrations with an all-new menu and all-you-can-eat promotion. We saw long queues and new customers. We are now a proud food service sponsor of the 2022 Olympic and Paralympic Winter Games in Beijing. We are honored to work with the Olympic Committee to promote Olympic values of excellence, respect and friendship here in China to our millions of members and customers. These achievements show how Yum China has become deeply ingrained in the lives and memories of millions of Chinese people. From the first phase of KFC in 1987 in Beijing, to trying something new at Pizza Hut, we are proud to be the largest and still growing restaurant company in China.

With the combined efforts of our team, we continue our sales recovery, and importantly, remained profitable in this quarter. This profitability is a reflection of our resilience, our adaptability and the strong dedicated execution of our team.

As we enter the third quarter, I look forward to continuing our innovation journey. We are cautiously optimistic. The recent regional outbreak highlight that recovery is nonlinear and uneven. While the summer season will be challenging, I'm grateful to be leading a dedicated team, ensured that we are building a strong and stronger Yum China.

So let's talk about digital strategy. Benefits of our digital strategy were particularly evident over the past few months. I would like to take some time to talk about how our member program and digital ecosystem have built our resilience, both for the short and long term.

Our over 265 million members provide a strong base for engagement. We interact with members within a digital ecosystem supported by our Super App, strategic partnerships with online platform and in-store digitization. Whether letting our customers know about our contactless delivery model or promoting weekend-specific offers, we reach our members faster with greater flexibility and at lower cost. Member sales accounted for over 60% in the second quarter. While overall sales declined during the outbreak, our year-on-year member sales grew by double digits. We acquire new members in innovative ways. Using popular social media apps and websites, we convert online traffic into in-store sales. We also engage at the corporate level. Over 10,000 corporations have signed up to our corporate delivery program, bringing entirely new groups of customers to Yum China.

Once members are acquired, we are able to design more targeted promotions, which improves the stickiness of our members as they use our Super App or mini programs, eventually upselling members into our Privilege program. We have sold close to 10 million Privilege subscriptions this year. Frequency and spending of these loyal users is more than double presubscription levels. Overall, we've doubled the average revenue per active member over the past few years. Our members are increasingly loyal to our brands.

Engagement is crucial for our member retention. Over years of consumer insights, we have developed award-winning games, marathon clubs and even one of the largest online children book store on our KFC app.

Whether through short-term promotions or long-term member engagement, our digital strategy extends across brands and channels from dining, delivery to take away. With this solid digital foundation, we are well positioned to capture future growth opportunities.

Off-premise dining remains the key pillar of growth. Delivery sales accounted for 29% of sales in the quarter, up 36% year-on-year growth. Our delivery business is top of mind with our consumers. It's consistently rated highly in taste, convenience and value. Our dedicated delivery riders once more support growth during this time.

At Pizza Hut, digital engagement drove incremental takeaway growth. With redesigned menu and packaging suitable for takeaway. We use our digital channels to communicate the value and convenience of our 1-person set meals. Over half of all takeaway orders were done through mobile.

I'm proud of our achievements thus far, but there's much more we are targeting. From ready-to-cook, corporate and late-night deliveries, we have the scale, the resources and the vision to capture those future opportunities.

Now let's move on to menu innovation and value promotion. Our digital initiatives rely on an enticing innovative menu to get customers excited. Pizza Hut launched its new platinum menu in conjunction with its 30th anniversary celebration kickoff. Learning from successful limited-time offers, this menu is substantially fresher. Extending our appeal to young and family-oriented customers, we showcase our pizza innovation with our Pizza Air series or Bo Cui Bing Di Xi Lie, thin crust pizzas that appeal to smaller appetites. We extend our leadership in the steak category with thick cut Angus steak and importantly, made steak available for delivery.

Our Monet afternoon tea sets. We have virtual reality effect of Monet paintings in select stores that appealed to our young social media-savvy customers. Many menu items also got an upgrade. Our baked crayfish with cheese got high marks on value, and our lasagna was appreciated by young and old alike. I'm really excited about all the innovation in our 30th anniversary menu. The look and feel show our our Pizza Hut positioning, which is always something new. So I hope you will try it soon.

KFC brought back favorites, beef wrap and taco junior during the quarter, with crayfish in the taco to showcase abundance and premium. We extended drinks, desserts and late-night delivery lines. Our breakfast tofu pudding, which is Jing Dian Feng Wei Dou Hua quickly became a crowd favorite, and we showcased festival innovations with exciting products such as scallops, salted egg yolk rice dumpling. In Chinese, that's Gan Bei Xian Dan Huang Ba Bao Zong.

To drive traffic, KFC also launched value campaigns throughout the quarter. Our plant-based protein pilot was successful. Introduced across KFC, Pizza Hut and Taco Bell, they sold out quickly. Once the domestic production may be scaled, this has great potential to bring our brands to new and discerning consumers.

Now let me wrap up with a few brand-specific observations. First, KFC. KFC continued to demonstrate its resilience and operational excellence. Second quarter transactions substantially improved compared to the first quarter. Compared to the rest of our portfolio, KFC has a higher concentration of stores located in transportation and tourist hubs. And they are impacted by the downturn in business, and holiday travel, delayed and shortened school holidays, together with lingering effects of the outbreak on consumer behavior will continue to pressure sales. We will work on providing value and occasion to draw customers in, but recovery is likely to take an extended period of time.

Next, Pizza Hut. Our 30th Anniversary all-you-can-eat campaign went viral with over 80 million views and comments on social media, driving long queues in our stores. We have seen encouraging signs of transaction recovery. However, the delayed and shortened summer holidays will impact our business as well. We will strengthen our offerings for individuals and for delivery and takeaway, while family dining volumes recover.

Third, Taco Bell has now expanded beyond Shanghai. We opened our first flagship store in Shenzhen, and we'll be opening soon in Beijing. We are excited to bring this new cuisine to more of China, and we are working hard to create an appropriate business model just right for Chinese customers.

Finally, integration of our Chinese dining unit is on track. Our Little Sheep and Huang Ji Huang store sales are recovering, and we are leveraging the YUMC network in areas of delivery, retail and logistics to further Huang Ji Huang's capabilities.

With that, I will hand over the call to our CFO, Andy Yeung. Andy, please?

Ka Wai Yeung ***Yum China Holdings, Inc. - CFO***

Thank you, Joey, and hello, everyone. I will first address financials and developments in the second quarter, then provide some color on our outlook. Unless noted otherwise, figures mentioned refer to the second quarter of 2020. All percentage changes are before the effect of foreign exchange.

Now let me start with the second quarter results. With over 99% of stores opened, total 2Q revenues recovered to 93% of the prior year. In the first quarter, revenues were 79% the prior year level. Both of our core brands have quarter-over-quarter improvement in transaction volume. However, traffic is still below pre-COVID levels.

KFC's same-store sales recovered to 90% of prior year compared to 89% in the first quarter. We saw sequential increases in average unit volumes in April and May but a weaker June. While weaker weekday and dining recovery benefited from our promotional campaign, regional differences persist. Our transportation and tourist hub sales, which accounted for high single-digit sales mix, were still significantly and negatively impacted. The higher mix of younger school-age customers meant that the delayed and shortened school holiday had a bigger impact on KFC and Pizza Hut. Lingering effect of the outbreak on consumer behavior remained a headwind.

Pizza Hut same-store sales recovered to 88% of prior year's. This is a significant improvement from the fiscal -- the first fiscal quarter. We used -- segment sales were 69% of prior year.

Relative to KFC, Pizza Hut has a significantly lower exposure to transportation hub locations. Our store in lower-tier cities continued to perform better than stores in the higher-tier cities, partly driven by a higher concentration of transportation hubs and tourist locations in higher tier cities. Our strong brand equity also helped relative performance in the lower-tier cities.

The sales recovery is nonlinear and uneven. As Joey mentioned, growth momentum was slow by the resurgence of regional infections, delayed and shortened summer holidays and continued anemic sales at major transportation and tourist locations.

We opened 169 stores, mostly at KFC. Construction activities have mostly normalized, and the pace of the new deals is on track. Restaurant margins were 13.7% compared to 14.7% last year, mainly due to sales leveraging, which was partially offset by our efforts to control costs and one-off benefits. Cost of sales was 32.9%, a 1.4% year-over-year increase. While protein supply eased in the second quarter, our contracts are generally signed 3 to 6 months in advance. Commodity inflation for the quarter was 3%. Value promotions are key to drive traffic into our stores, which will also impact our margins. Cost of labor was 22.7%, a 0.7% year-over-year decrease. Productivity improvements and temporary relief more than offset the impact of sales leveraging and wage inflation. Within this figure, wage inflation was 3%. This was subdued in many of our markets as government-mandated increases in minimum wage were deferred.

An increased proportion of delivery sales contributed to higher labor cost percentages. These factors were mitigated by digital scheduling tools and profit management real-time monitoring, which drive improvements in productivity.

Lastly, reductions in social insurance payments were roughly $30 million. We negotiated approximately $10 million in rental relief in this quarter. We implement cost realignment measures and benefited from reduced social insurance payments. However, due to timing of government incentive receipt, G&A costs increased by 8% year-over-year. Excluding the impact of timing shift of government and other onetime expenses, G&A would have decreased slightly year-over-year. We recorded impairment charges of $24 million. We achieved operating profit of $128 million, bolstered by cost realignment and onetime relief.

Looking below the line, our gain from equity investment in Meituan was $45 million, which is before $40 million in U.S. income tax, related to gains recognized during the second quarter and prior periods. Our effective tax rate was 25.2%. Net income was $132 million. Our diluted EPS was $0.34. And adjusted diluted EPS was $0.35.

Now I will turn to our outlook for 2020. The situation is still evolving. However, resilience, adaptability and innovation are key strengths as we navigate an unprecedented environment. Our outlook is based on certain key realities. One, transportation and tourist volumes continue to be anemic; two, the delayed and shortened school holidays will impact sales momentum; three, the COVID situation is unpredictable. With its lingering effects and regional outbreak, we expect the recovery to remain nonlinear and uneven; four, sales deleveraging will continue to pressure margins, especially as onetime government and rental relief are phase out.

In response to this reality, we need to be patient and vigilant in rebuilding our sales momentum, focusing on our strength in menu and digital innovation. Successfully leveraging our member base and digital ecosystem to drive frequency and spend will be key. Our promotions are adaptable. And we have seen some successes in building weekend recovery through greater value offering. Lastly, we are taking decisive actions to realign our cost structure.

As we look ahead, we continue to target 800 to 850 new stores for this year. Investment in digital, technology and supply chain continues. Our 2020 CapEx plan is unchanged in the range of $500 million to $550 million. We expect wage inflation to stay at mid-single digits this year as minimum wage increases have been delayed in many provinces.

Finally, while protein supply in China appears to be loosening, our best estimate of 2020 commodity inflation is for low single-digit.

Risk to global supply chain remain, which may have potential implication to our domestically sourced products. As previously announced, we will increase our stake in the Suzhou KFC joint venture. The transaction is expected to close in August, subject to satisfaction of closing conditions.

We see the new normal of reduced travel, social activities with bouts of disruption as secondary regional outbreaks occur and are contained. The lingering effect of COVID will impact consumer behavior. That being said, with our digital infrastructure, solid execution and strong balance sheet, we are prepared to capture opportunities for recovery and growth.

With that, I will pass you back to Debbie to start the Q&A. Debbie?

Debbie Ding ***Yum China Holdings, Inc. - Senior IR Manager***

Thanks, Andy. We will now open the call for questions.

(Operator Instructions)

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Chen Luo from Bank of America.

Chen Luo ***BofA Merrill Lynch, Research Division - MD***

So I noticed that you highlight a few risks and challenges throughout the conference call. And also in the earnings announcement, you also mentioned that these challenges will continue to impact operations in July. Can you help to give us a little bit more color on how we compare the July performance with June? Are we seeing any sequential improvement? And just now, Joey, you also mentioned that the summer season is likely to be challenging. And do we have any rough idea as for the trend in Q3 versus Q2?

Ka Wai Yeung ***Yum China Holdings, Inc. - CFO***

Chen Luo, let me take this question first, and then maybe Joey can add a little bit more color later. In terms of the sequential improvement in July compared to June and as we mentioned before on our prepared remarks, right now, there's a couple of headwinds that we see, right? So we have seen the transportation hubs as well as the tourist locations, which account for high single-digit of our sales mix, being impacted quite significantly, right, by the COVID effect, down 50%, right? So I think unless there are significant changes in the situation, I think that will continue to be a headwind for us.

Now we also mentioned that shortened and delayed school holidays, which should have a large impact on KFC compared to, say, Pizza Hut. As you know, normally in China, school holiday started in -- generally, it would be in June. This year, because of COVID situation, it has been delayed until mid to late July, depending on where the location, the provinces and whatnot. So I think it will still have some impact on the -- in July.

For the fourth quarter, we also -- this year, we have a holiday shift for the mid-Autumn festival, right, which last year was in September. This year, it's going to be in October 1, I think. So there's also a holiday shift impact, right? So that will probably impact a couple of points, if you look at that kind of shift. So those will remain -- some of this.

And then, of course, in June, we have this new outbreak in Beijing that also impacted sales in, not just in Beijing, but the surrounding provinces. So the situation has improved, very significantly in Beijing. However, we do see other regional outbreak, for example, in Liao Ning, Da Lian, right, and also in Hei Long Jiang. So we do expect that kind of potential regional outbreak to persist until the -- either the COVID-19 have a vaccine or effective treatment, I think we'll still continue to see potentially mini outbreak regional impact.

Obviously, this summer, we got a lot of rain here in China Eastern part. Along in Yangtze river, I think a lot of provinces have flooding. And the flooding is quite severe compared to the past few years. So we do expect that, that would have some impact on our Eastern part of operation, which is our strong base. So in Hua Dong district, right? So I think we still see pretty strong headwinds and some of these difficulties in the third quarter.

Now however, as we mentioned, we have a very strong digital platform. And we have strong, very strong execution, including our logistics operation, which continues to work well even in the midst of the flooding situation in some of the regions. So we would make our efforts to, one, to obviously -- to drive sales recovery and then also continue to be vigilant on our cost funding as well. So we have made some cost alignment, as we have mentioned on our prepared remark and also our earnings release. That is showing up quite well. So if you look at our labor activities for the quarter, they have improved. If you look at our G&A, right, so excluding all these onetimes and timing issues, we actually see G&A decline year-over-year, which is quite significant, given the fact that we normally would have merit increase, wage increase and new hire. So that's my comment. Hopefully, addressed your questions.

Joey Wat ***Yum China Holdings, Inc. - CEO & Director***

Thank you, Andy. I guess, in the last earnings release, we mentioned the challenge in transportation hub and tourist location and the summer holiday delayed and shortened. And the delay -- shortened 2 weeks in June, 2 weeks in July. And for this earnings release, Andy just also mentioned the regional resurgence of the COVID-19 and the little -- not-so-little flooding challenges in different parts of China. So I think we are ready for next question. Thank you.

Operator

Your next question comes from Lillian Lou from Morgan Stanley.

Lillian Lou ***Morgan Stanley, Research Division - Executive Director***

I have a follow-up question on the same-store sales growth. Obviously, I think Pizza Hut did very well, actually better than that in second quarter. Well, I think Joey also mentioned in the opening remark that KFC was more affected. Just wanted to understand a little more in detail in terms of the impact to those 2 major banners' recovery pace, why it's a little bit different right now under the headwinds.

And related to that is more the outlook, how we're going to picture KFC and the Pizza Hut same-store sales growth recovery pace in second quarter or the fourth quarter?

Joey Wat ***Yum China Holdings, Inc. - CEO & Director***

Thank you, Lilian. For KFC and Pizza Hut, as I mentioned in my presentation earlier, I am proud of both of the progress, Q2 has been difficult. But both brands did well in their own different way. And let me make a few comments one at a time. KFC reached to 89% same-store sales within quarter 1, which is very, very quick, supported by a few weeks of strong sales before Chinese New Year and also very few trust restaurants opened during the pandemic time. So KFC rebounded very, very quickly.

And Pizza Hut, because of the closure of dining business in many of our stores during Q1, so sales was more impacted. Once the dining business was allowed during Q2, the dining business for Pizza Hut bounced back quite quickly. As I can share with you that the Pizza Hut dining business recovered from 40% to 55% during Q2. So that helps.

In terms of the recovery path and outlook. For both brands, that really come down to the theme that we talked about, the resilience, adaptability and innovations. And to be specific, I'm going to talk about short term and long term. So for the short-term initiatives, which is something that we have been doing from the very beginning of Q1 and then throughout Q2, is value, a lot of value promotions because we see that as a challenge and also opportunity. And as I mentioned in the last earnings release, the weekend was challenged. And thus, in the Q2 time, we have shifted our promotion towards more weekend and holiday, and we are seeing the results.

And then second, short-term initiative, which is something that we have been doing, have been doing quite well with menu and innovations. I'm talking about the product innovations. So for KFC, we have the exciting Zong Zi, the Duan Wu Jie Dragon Boat Festival Zong Zi. And we have the Dou Hua, which is a very, very popular item. And then for Pizza Hut, we have something exciting, the roast -- steak rice and crayfish pasta. And for people in Wuhan, we even launched Re Gan Mian with crayfish with pasta. It was sold out very well in Wuhan. So these are the short-term initiatives that we've been pushing.

And then, on top of that, we are also taking this year, as a challenge but also opportunity, to work on our short-term and long-term business model transformation throughout innovations here. Let me give you some examples.

So for KFC, we have been working very hard to extend our business to B2B2C, which is the corporation delivery members. We have been preparing for it. And the COVID-19 gave us perfect opportunity to give a push. So by now, we have signed up more than 10,000 companies in our corporate delivery membership. And you can see the impact of our number in TA increase in both Q1 and Q2. In quarter 1, KFC TA increased 20 -- 27%. For Q2, it's 12%. So it's not only driven by delivery. It's also driven by corporate delivery, very big order. Not to mention, it gave us another source of traffic, Si Yu Liu Liang on top of our own app. So that is the short term and long term.

And then, of course, the contactless delivery that is very popular throughout the world right now. For Pizza Hut, our hard work in many fundamental capabilities come through. So we've been working very hard on digital opportunity. And guess what, we get our mobile ordering before Chinese New Year. We did not know the COVID-19 was coming. And then COVID-19 came, it became a very good platform for takeaway and mobile order. So our mobile order or digital order just increased significantly. And Pizza Hut alone, the digital order for Q2 is 61%. And that, compared to last year's 29%, it almost doubled. So again, the business model transformed. And for Pizza Hut, when we add the takeaway business, which is very value driven, it's very much incremental because it's for 1 person, together with delivery, the non-dining business become more than 40% of our business. So we become less reliant on dine-in business. So that is an example of both short-term and long-term transformations.

And then I would like to mention the members. We have reached 268 million members. And the members are our digital assets to allow us cross-sell between the brands and between the business within the brands to increase frequency and cross-sell. As I mentioned in my presentation earlier, we saw the doubling of average revenue per active user, and that's very exciting in the past years and for the coming few years.

And last but not least, as Andy mentioned earlier, we are accelerating our digitization to help cost realignment as well. And all these are very long term but also short term.

Last, but not least, is our new builds and store refresh. So not only we are recovering sales, we are innovating our business model. We are building our long-term prospect in China because despite the short-term challenges here, we are committed to China, and we are very excited about the future development opportunity here. Thank you, Lilian.

Operator

We have our next question from Michelle Cheng from Goldman Sachs.

Michelle Cheng ***Goldman Sachs Group, Inc., Research Division - Executive Director***

Joey, Andy, a question about Pizza Hut. The second quarter improvement is quite encouraging, as you mentioned. We are pushing these takeaway, 1-person set, and et cetera. So can you share with us what are we going to focus in second half? And given this kind of like sales mix change, so like are we going to see like some downsizing of the store or some new store format going forward?

Joey Wat ***Yum China Holdings, Inc. - CEO & Director***

Thank you, Michelle. For the revitalization of Pizza Hut, I stay away from the turnaround because Pizza Hut was never so bad that need a turnaround. It has always been a very profitable business. But for the revitalization of Pizza Hut, we always have a very clear step-by-step progress. And good things do take time. In the last few years, it took us 18 months to turn the same-store sales from negative to positive, which is not slow. But let's look at what are the key things we have done in the last few years.

One is about the value for money and the quality of the product. So by last year, we managed to upgrade more than 70% of the menu. And by this year, when we launched the 30th year platinum menu, we further upgraded the menu. So that is a really good progress, and the momentum will continue because Chinese customers does want and require good food with great value for money.

So -- and then what are the other things that we have done? We have taken our time to rebuild our delivery infrastructure. So that's the hard work for 2018. We took the delivery rider back to our system. We rebuild it to improve the quality of delivery. Without the quality of delivery, without ensuring pizza will reach our customer nice and warm, it's very hard to grow sales. So we did the hard work, and you can see the impact of the delivery business growth in 2019.

Now in the last 2, 3 years, we also took the chance to rebuild our digital infrastructure, anywhere from member sales to mobile, to digital ordering, you name it. And right now, the digitalization. So now we have seen the increase of the preorder, digital order, that all help save our labor costs but also the business on -- to build the business on takeaway. That come through, but it does take time.

With this infrastructure in place, not to mention, we have also upgraded our team. There are a lot of people movement here in the brand in the last few years, and I'm quite happy with the team right now. I think we have a fantastic team who are focused, who are innovative, who work hard, who can execute well. And what else are we doing to build the business in the short and long term? As you mentioned, Michelle, the new build and store refresh. We have focused on store refresh in the last 2 quarters instead of building new stores. Actually, if we look at the last 3 years, we have been very conservative with building the new store until we get to the right business model. However, we have not been slow to upgrade our stores.

Since 2017, we have refreshed about half of our entire Pizza Hut store portfolio. In the process, as you can imagine, we reduce the store size, we upgrade the store look and feel, we improve the efficiency. And we'll continue that, we'll continue to take the aggressive pace to refresh our stores. At the same time, when we are rebuilding the new store, you will be able to see the total portfolio probably won't move that much, but the content, the component within the portfolio will change from sort of bigger store to sort of smaller store. Because even for the new stores that we rebuilt in the last 2 quarters, the majority of them are much smaller stores, which is the satellite stores that I introduced to our investors back to last year Investor Day, much smaller, much better return of investment, much more suitable to increase the density of the store to improve the quality of delivery. So these are the few things that we are working on.

And last but not least, the cost realignment. This is not short term. I mean, anyone can do the short term cost cut, but what we are looking for is long-term cost realignment so that we are learning enough from this challenge and also taking advantage of the open-mind situation or open-mind opportunity for our staff during this difficult time to really rethink about our cost structure so that we can benefit from the realignment of cost structure in the very long term. Thank you, Michelle.

Operator

Your next question comes from the line of Kevin Yin from JPMorgan.

He Yin ***JPMorgan Chase & Co, Research Division - Head of Greater China Consumer Research***

I have 2 questions. The first one for -- a technical question for Andy. Can you help us to understand why the operating leverage impact on Pizza Hut is not that bad as at KFC? Because if you look at the first quarter, second quarter, their margin -- restaurant margin is pretty stable versus KFC's continued declining. So that is a technical one.

Second one, I'd like to know more on the impact from the flood. Can you give some vivid example or vivid case that like in some region, province, how badly the sales -- the store sales are a negative impact? I mean, in some specific region, which we had some very bad flood, and how bad is the sales store -- the store sales decline?

Ka Wai Yeung ***Yum China Holdings, Inc. - CFO***

Thank you, Kevin. So let me take your first question regarding obviously the impact on KFC and Pizza Hut and how they're different. So I think there's questions about the performance of the 2 brands. I think as we may have mentioned on the call, the SSG, which is same-store growth, was 10% decline in KFC and about 12% in Pizza Hut, which is quite an improvement, right? So in the -- for KFC case, it's improved by 1% and then more pronounced improvement at Pizza Hut, which in the last quarter was down about 31%, right? So that's quite a lot of improvement there. But that still masks the actual improvement, right? So if you look at both brands, because the SSG calculation actually would exclude temporary store closure, right? And so if you take out -- if you look at the store reopening in the second quarter, the system sales recovery actually improved by a bit on -- at both brands and, on a year-over-year basis, improved from negative 20% in Q1 to about 7% in Q2. So that's important. And obviously, we also see April and May improvement -- sequential improvement in both SSG and also overall system sales improvement. As we mentioned, this got impacted by some events in the -- in June and early part of July. One is that there's a regional outbreak in Northern China. And then there's a delayed summer holiday. And then of course, as you mentioned, there's flooding in June and July in part of -- the large, large part of China. So I think that's very [personal].

And then -- and as we mentioned, obviously, KFC have a very strong recovery right after the outbreak. Pizza Hut, in the first quarter, more impacted and, therefore, see a relatively better recovery. But both brands actually have recovered very well in terms of operations.

In terms of the margins as well. So I think if you look at the margin on both -- at both brands, it has improved. And I think this is -- hopefully, will continue to be the case as sales deleveraging are beginning to ease as we move forward in the coming quarter. But obviously, KFC has been very profitable before, right? The -- UC margin was about 17%, almost 18%. And then sales deleveraging would impact a little bit more on that. Particularly, the reason is because if you look at transportation hub, which is a -- not only account for the high single-digit of our sales but also account for low double-digit of our profitability. And that impact in that sales trend over in transportation hub and tourist location would have a disproportionate impact on KFC compared to Pizza Hut. But I think if you look at both brands, labor productivity, cost control will help us to see sequential margin improvement.

Joey Wat ***Yum China Holdings, Inc. - CEO & Director***

Let me -- thank you, Andy. Let me make 2 comments about the flooding. This year, we do have a lot of water. I mean, the water volume is comparable to 1998. But the impact is nothing like 1998. Let me give you a big picture, and then I'll go through why. The big picture is lower-tier city sales actually recover better than that of the top tier cities. And that includes the regions that were more impacted by flooding. That's mainly like Jiang Xi and Hua Dong area, but mainly in the lower-tier cities. So why the sales in lower-tier cities hold up -- still hold up slightly better despite the flooding? Because there are 5 reasons. One is a lot of these lower-tier cities, that means we only have a pocket -- some pocket of stores being impacted, not huge scale. So where some stores, impact of that is not at the scale of tier 1 cities so we can handle that kind of challenge. But also due to the second reason is our stores tend to recover much faster than our competitors'. So one example is the one little town, the gas got turned off by the city government, the entire town. But actually, that means more business to our store because our stores use electricity, not gas. So when the customer could not have hot food at home, they come to KFC. They could have hot food there. Not to mention, we always have free chargers for your phone and then free clean water if needed.

Third reason is there's a lack of transportation and tourist hub in the small town -- city. In the small town, the transportation hub and the tourist hub, as Andy mentioned, is almost at, together, high single digit -- almost double digit of our sales. And when it's severely impacted, it does impact our overall number. But the small town, usually, the stores are less impacted by that.

And fourth reason is we are one of the few trust brands in the lower tier cities. So during the difficult time, we actually benefit from it.

Last but not least, delivery growth actually is even higher in the lower-tier cities than top-tier city. So I hope that gives you a better color of the dynamic of the lower-tier cities despite the flooding challenges. Thank you, Kevin.

Operator

Your next question comes from Anne Ling from Jefferies.

Kin Shun Ling ***Jefferies LLC, Research Division - Equity Analyst***

So I have a question regarding the -- some of this one-off benefit. Andy, you mentioned about like the $30 million in second quarter on the social insurance payment and also like 10-year -- $10 million rental relief. If we look at, like yesterday's start-ups results, they also mentioned about like some VAT exemption, which we saw the announcement back in February that all the catering business and lodging business will have this tax reduction. That helped their same-store sales as well as their profitability.

I just wonder like whether for this quarter, are you enjoying that any sort of this kind of like VAT exemption benefit? And since this benefit will last until December, may I know like how soon will you be able to get this kind of benefit? What are the procedures on this program? And is there any additional onetime benefit in this quarter and in the foreseeable future?

Ka Wai Yeung ***Yum China Holdings, Inc. - CFO***

Anne, I will answer your questions about it. Can you hear us?

Kin Shun Ling ***Jefferies LLC, Research Division - Equity Analyst***

Yes, yes.

Ka Wai Yeung ***Yum China Holdings, Inc. - CFO***

Okay. So thank you for the questions. VAT and its impact, a little bit more complicated. There's obviously, we are aware and have looked into the VAT reductions, temporary suspension of that by the government at the beginning of the year. And generally, VAT that we collect from our sales is generally less than our VAT credit for our company services for the input cost. So there's offsetting factors, right? So you have the sales to consumer, and we have also used product and services, and that's offsetting.

So after very careful analysis that we have done, we don't see there's meaningful impact on our top line or bottom line from the VAT exemption that the government have launched this year. Obviously, we'll continue to look into it because tax is now -- these are very complex issues. But in regard to VAT, would have very limited impact on our sales or our profitability.

In terms of other onetimes, so we obviously received the social insurance payment reduction in both the first quarter and the second quarter. But as you know, that was because the government launched that in February and then have extended that to June. Unless there's some new update, that may go away in the third quarter. So unless the government extend the program again, we may see that one-time relief to go away.

The other one is that rental relief. We see that in the first quarter, after negotiation with the landlords. Demand is less in the second quarter compared to the first quarter. We do expect that as the recovery continues, that would also be phased out.

So I think some of these one-time impact maybe lessened in the third quarter and potentially also in the fourth quarter.

Kin Shun Ling ***Jefferies LLC, Research Division - Equity Analyst***

Okay. And Andy, when will we know that the government might extend the social insurance payment exemption?

Ka Wai Yeung ***Yum China Holdings, Inc. - CFO***

Yes, when they announce it, then we'd know.

Kin Shun Ling ***Jefferies LLC, Research Division - Equity Analyst***

There's no like time line on that part?

Ka Wai Yeung ***Yum China Holdings, Inc. - CFO***

No. I think in some provinces, it's really up to the government to announce the program.

Operator

Your next question comes from the line of Christine Peng from UBS.

Yan Peng ***UBS Investment Bank, Research Division - Executive Director & China Consumer Staples Sector Analyst***

So I just have a question regarding the cost alignment you mentioned earlier in your presentation. So can you elaborate as regards to, number one, what magic you have been taking to do this cost alignment? And secondly, what's going to be the margin implication, for example, in 2021, once the revenue normalized to the pre-COVID-19 level, especially for Pizza Hut?

Ka Wai Yeung ***Yum China Holdings, Inc. - CFO***

Okay. Christine, thank you for your questions. Yes, so obviously, as we look into the cost structure and we align that, there's 2 sort of like driving goal for us. One, obviously, is to continue to make our cost structure more flexible to handle contingency, such as we have seen in COVID-19. The other part is that we'll continue to try to drive our overall cost structure more efficiently. So that as Joey mentioned, taking advantage of the current situation where folks are more aware of the need for better cost control and better cost realignment to push through some of the initiatives that would help us to make our cost strategy, cost structure a competitive advantage for us in the longer term.

So with that in mind, so we go through sort of like each major category of our cost component. Now so if you look at our -- for example, COS, obviously almost all variable. And -- but we're also focusing on using technologies, using product innovations to sort of improve wastage in the restaurant level, to manage inventory turns better, so that can handle fluctuations in demand shift, for example. In labor, for example, as we mentioned before, over time, we have shift some of the labor component into more variable portions with more flexible pool scheduling, et cetera. Again, give us some resiliency in terms of handling the flux in sales changes.

And then also, if you look at -- obviously, we benefit -- sow the benefit, but in the longer term, it's the labor productivity improvement that we use technology to drive, that really help us in the long run, to maintain that labor productivity improvement that we have seen over the past few quarters, right? So we'll continue to focus on that, invest in technology, digital technologies, both in the storefront as well as in the back of the kitchens as well as our offices to make sure that labor productivity to continue to improve.

Now if we turn to, for example, occupancy and other expenses. We have variable components above that, royalty fees, advertising, marketing, weekend -- that's sort of somewhat tied to sales. But if you look at over the past few years, for example, we have reduced the upfront investment costs for our store opening. That have a beneficial impact, which is from a per store basis, depreciation have decreased even though it is fixed, okay, per store basis.

And if you look at rent, for example, we have 80% of our lease have a variable component to it. If you look at the rent cost, only 60% of that is fixed. So we are doing some flexibility in our rental expenditure. Obviously, we're working very hard to negotiate better lease and better contract whenever possible, given the current situation.

Now if you look at G&A, as we mentioned, we have done a very large initiative looking into G&A, and that have been ongoing for the last couple of years now. We'll continue to see our effort there. So if you excluded, for example, as we mentioned, you look -- excluding some onetime and timing shift, you'll actually see G&A expenses declining year-over-year. So that will continue to be our focus, which is basically realign the overall cost structure, make us more flexible, more competitive in the long run.

Debbie Ding ***Yum China Holdings, Inc. - Senior IR Manager***

Andy, can I just ask the...

Ka Wai Yeung ***Yum China Holdings, Inc. - CFO***

Sure,...

Operator

Sorry. We have 1 last question from Xiaopo Wei from Citigroup.

Xiaopo Wei ***Citigroup Inc., Research Division - Director & Head of Asia-Pacific Consumer Research***

I have a very quick question on Pizza Hut. If you look at the Pizza Hut recovery, actually, not only the top line but also the profit improved a lot Q-on-Q. You mentioned a lot of factors. I think it will be short term, but let's recall what Joey have been talking about, the revitalization effort at Pizza Hut in the past 2 years. Shall we say that the behavior changes of consumer post COVID may actually put Pizza Hut in a better position of revitalization post the COVID outbreak? Because we are seeing other category dining player to actually recover much slower than Pizza Hut in my observation. Could Joey you give us other color on that?

Joey Wat ***Yum China Holdings, Inc. - CEO & Director***

Xiaopo, thank you. Well, we are certainly grateful to see the recovery in both top line and bottom line. As I mentioned, the dine-in recovery as well, and the bottom line recovery, of course, to a great extent, is because of the sales leverage. Our sales is back so the bottom line definitely looks better. But with that said, there are certainly a few things that happened here to help us recover better. I don't know whether I would say COVID-19 gave us opportunity, or we just have been prepared in the last few years. And it just happened that the timing is not too bad for us. The innovation capability, the food improvement certainly helped a lot because our team right now is so innovative. And it's something that I mentioned in the last earnings release, we are able to use whatever ingredient in our store to come up with very cost effective and efficient food for the takeaway business. One example is the Ju Fan the steak rice, which we use actually our pizza oven to cook. Just go through like -- use the Liu Shui Xian, like use the pizza oven, but were very efficient and efficient in terms of cost structure as well, and it worked very well for the takeaway, for the 1-set lunch -- 1-set meal, and thus -- therefore, it worked. And that is not because COVID gave us the opportunity, because we've been working on the innovation capability.

And then secondly, the delivery. We have our own delivery rider when we really need it. As you can imagine, if we do not have our delivery rider, even if the business is there, the -- whether you have or you don't have the delivery rider decide whether you have or don't have the sales, as simple as that because everyone will be fighting for the delivery rider at some times such as COVID-19 or big rain or snow, whatever, et cetera.

And then the third is the digital effort. The digital capability infrastructure of Pizza Hut is slightly behind KFC because the KFC revitalization happened much faster. It happened as early as 2015, and then Pizza Hut started later so the infrastructure follows. But once we get the infrastructure ready, the preorder, the mobile ordering, the digital payment, et cetera, et cetera, it just worked. Our takeaway business just happened. And thus, it was like less than 5% of our business last year, now it's double digit of our business, and it's quite substantial.

Not to mention, last but not least, our long-term, very strategic focused membership. Pizza Hut itself has over 80 million members now. And the sales per member is more than 50%. And the big number, just imagine, 50% of our sales, we can reach out to the customer directly at very low cost efficiently, and that helped us drive the business.

Last but not least, our store environment is much better because of the hard work in the last few years. So when the store environment looks much nicer, when the food is good and the price is good, it allowed us to do some very effective promotion like zizhucan all-you-can-eat or steak and crayfish. And say, on crayfish, we can put it in the all-you-can-eat menu because our supply chain is very efficient. So it all just -- all the hard work come together particularly during this difficult time to allow us to recover probably slightly better than the other casual dining restaurants.

Last but not least, is Pizza Hut does not have high proportion of sales from transportation and tourist sites. And that is quite -- almost mid single-digit sales impact in same-store sales for KFC. Pizza Hut, we don't have the challenge in this particular time. So you can see why at our -- help Pizza Hut revitalization even during this difficult time. And we certainly are hopeful, and right now, we have the right team, right ads, the right product, right price, we are hopeful for the ongoing revitalization of Pizza Hut business as well. Thank you so much you, Xiaopo.

Operator

Okay. There are no further questions at this time. I'll now hand the conference back to your presenters for any closing remarks.

Debbie Ding ***Yum China Holdings, Inc. - Senior IR Manager***

Thank you for joining the call today. We look forward to speaking with you on the next earnings call, and that concludes today's call. Have a great day. Thank you.

Ka Wai Yeung ***Yum China Holdings, Inc. - CFO***

Thank you, everyone.

Joey Wat ***Yum China Holdings, Inc. - CEO & Director***

Thank you. Thank you.

Operator

Yes, ladies and gentlemen, that will conclude today's conference call. Again, thank you all for participating. You may now all disconnect.