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Q1 2021 Yum China Holdings Inc Earnings Call

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Yum China's First Quarter 2021 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I'd now like to hand the conference over to your first speaker today, Ms. Debbie Ding. Thank you. Please go ahead.

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

Thank you, operator. Hello, everyone, and thank you for joining Yum China's First Quarter 2021 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 contain forward-looking statements, which are subject to future events and uncertainties. Our actual 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. Joey will provide an update regarding recent development in our first quarter 2021 results. Andy will then cover the financial performance in greater detail. 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. Our first quarter results demonstrate the resilience of Yum China. We delivered $342 million in operating profit. System sales grew 34% year-over-year as same-store sales recovered with 10% growth. We accelerated our store expansion, opening 315 new stores in the quarter.

First quarter trading was adversely affected by the resurgence of COVID outbreaks and tightened public health measures. The impact was particularly pronounced in Northern China where cases spiked in transportation locations due to sharply lower passenger volumes.

I would like to thank our 400,000-plus employees and riders for their contributions during this difficult period. Many of them did not return to their hometown to celebrate the holiday with their families, instead serving our customers and communities. We delivered these

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strong results with the dedication and agility of our people.

The pandemic has introduced volatility and uncertainty to our trading patterns. Our team acted and reacted nimbly to changing conditions by planning for a variety of possible situations and deploying resources flexibly, we overcome operational challenges. Partnering with our suppliers and through inventory and production planning, our in-house supply chain managed complexity and potential disruptions to fulfill the demand of our 10,000-plus store network. Our operations team ensured the best possible level of restaurant staffing and delivery riders.

Our operational effectiveness is facilitated by our digital capabilities. Amid the fluid situation, we were able to quickly adjust offers and deploy labor as demand patterns shifted. It certainly reinforces our determination to continue investment in digital, technology and supply chain to fortify our competitive advantages.

Let me now update you on our core brands. First, let's start with KFC. KFC delivered operating profit of $327 million. System sales grew 24%. KFC continued to rapidly expand, opening 253 new stores in the first quarter. During Chinese New Year, we kept our operation simple to address the heavy foot traffic. We focused on our signature products of fried chicken and burger. Our Golden Bucket, (Xinchunjintong), offered abundant value and resonate well with customers.

With a variety of buckets, we captured different party sizes. In the off-peak period, we brought back KFC's signature beef wrap, (Nenniuwufang), and add crayfish to make it more premium and exciting. We also launched the new Chongqing Chili Pot Burger, (Malaxiangguobao). As part of the offering, we ran a special promotion with the popular action role-playing game, Genshin Impact, (Yuanshen), which was very well received by younger customers.

Our leading digital and delivery capabilities enable us to stay agile in this fluid situation. Despite the recovery in dine-in, delivery remains popular and accounts for 28% of sales, up 10% compared to pre-COVID level in first quarter of 2019. We drove this rapid pace of growth through our hybrid delivery model, omnichannel, marketing in our own Super App and aggregators drive demand, while fulfillment is done by our own dedicated riders. The -- this allowed us to capture delivery demand with sufficient riders, which was especially crucial in ensuring the success this Chinese New Year.

Delivery growth was also enabled by our continuous investment in strengthening our delivery capabilities. We started trade zone-based rider sharing in 2019. Last year, we upgraded our rider platform to improve zoning, rider routing and monitoring. We also started testing rider sharing between KFC and Pizza Hut. This is the first time we put the platform through a test during Chinese New Year peak period, and we are pleased with the progress.

Leveraging our digital assets and direct connections with our over 290 million members, we were able to shorten the lead time of our marketing campaign and modify them so that we can be more responsive to changing market conditions and consumer demand, of course. Our digital infrastructure also allow us to deploy the appropriate supply and staffing level where needed.

Digitization is essential to operating efficiency. As part of our end-to-end digitization initiatives, we pilot launched an AI-enabled restaurant inventory management tool, leveraging historical data, recent trends and real-time inventory levels. This tool improves forecast accuracy for our limited time offer. This enables us to optimize inventory and improve productivity.

Now let's move on to Pizza Hut. We are encouraged by Pizza Hut's strong recovery in the first quarter. Same-store sales grew 38%, and operating profit reached $60 million. These results reflect our efforts to improve fundamentals.

Let me provide an update along the 4 key pillars. First, our product offerings have significantly improved over the past few years. We have several successful product launches during Chinese New Year, such as surf and turf platter with seabass and steak, (Kaoluyuniupaipinpan); a flower-shaped stuffed crust pizza, (Zhixinhualun) pizza, and year of the ox holiday feast set, featuring signature products, (Bishengjuniuyan). These products were great for sharing and were well received by consumers.

In March, Pizza Hut refreshed its menu, replacing 40% of the menu with new or upgraded offerings, such as beef wellington and roast

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beef tapas. We also introduced Portuguese chicken curry, our popular dish on the delivery menu to dine-in.

We also have been unlocking the growth potential of breakfast and afternoon tea. We strengthened the menu with new offerings, such as French toast for breakfast and a 3-layer tea set for afternoon tea time.

Apart from good food, we have also been actively engaging customers both off-line and online. During Chinese New Year, we celebrate the festival with consumers by bringing in some of China's intangible cultural heritage, such as shadow puppetry and paper cutting into our stores. And then on the digital front, we have been strengthening our membership program in Super App to engage members and improve customer service. Our member base exceeded 90 million and contribute 55% of total sales, up 9 percentage points year-over-year. Digital ordering increased to over 80% of sales from 65% a year ago.

As table-side mobile ordering became more popular, we are also applying digitization and automation in our kitchens to improve operations. As part of our multi-phased intelligent kitchen project, we started to roll out an AI-enabled tool to pace food preparation and provide real-time metrics of kitchen performance. Initial results have shown improved efficiency and customer experience.

Third, Pizza Hut is strengthening its delivery, takeaway and ready-to-cook offerings. Delivery accounted for 35% of sales, an increase of over 10% from pre-COVID level in the first quarter of 2019. While growing from a small base, we are expanding our takeaway and ready-to-cook business through menu innovation and making them more convenient for consumers.

Lastly, we enhanced our store portfolio through accelerated remodels and new store formats. Since 2018, we have refreshed nearly half of Pizza Hut stores to make them more relevant to our consumers. This is over 1,100 stores. As we promised in the 2019 Investor Day, average store age is now below 3 years. The stores look great. The new small store format, which includes the hub-and-spoke model, which is also mentioned in the 2019 Investor Day, is creating more opportunities for Pizza Hut's expansion, enabling us to capture the growing demand for off-premise dining. Of the 44 new units that we opened in the first quarter, over half are in small store format. I'm confident that we will unleash Pizza Hut's growth potential through this combination of much-improved fundamentals, strong digital capabilities, multiple sales channels and rejuvenated assets.

In summary, we're pleased that our brands react quickly to the fluid market conditions and delivered strong operating profit despite sales pressures. Most importantly, we remain optimistic about our long-term growth opportunity in China. We will continue to accelerate store expansion for our core brands, grow our emerging brands and enhance end-to-end digitization and intelligent supply chain to build a bigger and nimbler Yum China.

While we are optimistic about our future, we remain cautious about near-term conditions. Occasional COVID outbreaks, like we saw recently in Yunnan, are a constant reminder that we are not back to normal yet. Tightened public health measures continue to be a daily routine and continue to have a lingering impact on consumer behavior. Dine-in volume is still well below pre-COVID levels, but we are not sitting still. Our nimble and innovative culture enable us to adjust marketing and operations quickly as things evolve.

With that, I will turn the call over to Andy. Andy?

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

Thank you, Joey, and hello, everyone. Let me now provide additional details on our first quarter financials and then share perspective on this year's outlook. Unless noted otherwise, all percentage changes are before the effects of foreign exchange.

Now let me first cover our Q1 financial results. We experienced substantial year-over-year growth in the first quarter as we began to lap COVID-19 impact period last year. Total revenue grew 36% year-over-year, led by same-store sales growth of 10%, new unit contribution and substantially fewer temporary store closures. Because of the volatility induced by the pandemic in 2020, the year-on-year comparisons are less representative. Looking at the 2-year change give a better sense of how we are trending back to pre-COVID levels. So we are providing pro forma measures here for convenience comparison with 2019.

Same-store sales recovered to approximately 94% of the first quarter 2019. Total revenue grew roughly 7% compared to first quarter

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2019, benefiting from new units and consolidation of Suzhou KFC and Huang Ji Huang. As we discussed in the last earnings call, the sales recovery was disrupted by the resurgence of regional outbreaks and significantly reduced travel. Travel volume during the 40 days Chinese New Year period was down approximately 40% year-over-year and 70% compared to 2019. This impact were more pronounced for KFC as it has more stores in the transportation locations. On a year-over-year basis, KFC same-store sales grew 5%, driven by the recovery of dine-in sales, while delivery remains popular. On a 2-year basis, sales recovered to approximately 94% with the same-store traffic at approximately 87%. Average [ticket] grew roughly 87 -- sorry, 8% versus 2019 due to increase in delivery mix. The respective average ticket of delivery and dine-in remain flat.

Pizza Hut same-store sales grew 38% year-over-year, driven entirely by the recovery of traffic. On a 2-year basis, sales recovered to approximately 95%, led by a 2% increase in traffic. This is a true testament to the success of the brand has achieved in executing its revitalization plan. Unlike KFC, the increase in delivery and takeaway mix contributed to lower ticket average versus 2019. Restaurant margin was 18.7%, up 8 points compared to last year. This was mainly driven by sales leverage, operational excellence and favorable commodity prices. Cost of sales was 30.2%, which was 180 basis points lower than last year. Commodity prices declined by 7% year-over-year, mainly helped by lower poultry prices. The impact was partially offset by investment in promotion to drive traffic.

Cost of labor was 23.3%, 220 basis points lower than last year. Sales leverage and labor productivity improvements more than offset wage inflation and diminished government subsidies. Given the labor shortage that we are experiencing, we are still actively seeking to hire additional restaurant staff. Occupancy and other was 27.8%, 4 points lower than last year, mainly attributable to sales leverage and savings in other operating costs. We also received approximately $6 million in rental reductions and government relief.

Compared to 2019, restaurant margin was relatively flat. The productivity gains and cost control offset sales deleverage, investment in value promotions and increased rider costs associated with the rise in delivery volume.

G&A expenses increased 24% year-over-year, mainly due to a timing shift of government incentives, gradual phaseout of COVID-19-related relief and the consolidation of Huang Ji Huang and Suzhou KFC. Excluding this impact, G&A increased 3%, reflecting our ongoing cost controls.

Operating profit was $342 million, compared to $97 million last year. The increase was mainly driven by sales and restaurant margin improvement, partially offset by the increase in G&A expenses.

Our effective tax rate was 29.6%. Net income was $230 million, and adjusted net income was $233 million. Excluding $16 million mark-to-market investment loss, it was $249 million, up 225% year-on-year. Diluted EPS increased to $0.53. This reflects common shares that were issued as part of our secondary listing in Hong Kong in September 2020.

Now let's turn to the outlook. As Joey noted, we are optimistic about our growth opportunities in China, but we remain cautious about the near-term environment. While the pandemic impact is subsiding, we must be mindful that the pandemic is not over yet. The full recovery takes time with an uneven and nonlinear recovery path.

We are confronting a couple of realities here. First, preventive measures will remain in effect. This will have a continuing impact on consumer behavior. Sporadic outbreaks remain -- remind consumer of the lingering risk. Social distancing and smaller gathering may persist for some time. Dine-in occasions are still well below pre-COVID levels.

Second, consumer spending is cautious. Government data shows that despite apparent recovery in domestic travel volume during Qingming holiday weekend in April, the related travel spending was still down over 40% comparing to pre-pandemic level in 2019. In fact, sales at our transportation location remains well below 2019 levels. Against this backdrop, we expect it will take time for same-store sales to fully recover to pre-COVID levels. We will focus on driving top line growth with compelling value propositions, more marketing campaigns, product innovations and digital engagement with consumer for both dine-in and off-premise occasions. While necessary, this initiative will pressure our margin.

Upon that, we face other cost headwinds. The tailwind of favorable commodity prices in the first quarter will likely gradually subside. At

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this time, we expect poultry prices to rebound and partially -- potentially turn into inflationary pressure later this year.

In addition to replacing plastic packaging with eco-friendly materials, we will also invest packaging upgrades for delivery and takeaway. We expect labor costs to increase in the subsequent quarters. There are 2 components to that. First, wage inflation was 2% in the first quarter as minimum wage increases were deferred in certain markets. We expect wage inflation to pick up in the second half of the year. Full year wage inflation should stay at mid-single digits.

Second, increasing -- increased hiring. In the past few quarters, we have been short of part-time workers due to COVID-related restrictions. We're working to increase restaurant staffing levels. While this will increase training hours and wage expenses, it's critical for our customer services and long-term viability.

We have approximately $6 million of temporary relief from the government and landlord in the first quarter. This was partly due to a timing shift of amount previously applied in 2020. We expect this support to taper off as the year progresses. As a reminder, we are lapping over $100 million relief in 2020. In the second quarter 2020 alone, we received approximately USD 50 million in relief.

Step-up investment in technology, end-to-end digitization and operational infrastructure will strengthen our capability and further solidify our competitive position. But in the near term, this will pressure our margins and operating profits.

To wrap things up, we're working diligently to drive same-store sales recovery and accelerate store expansion. We are also committed to invest to drive accelerated growth and create value for our shareholders in the long term.

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) Operator, please start the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have multiple questions in the queue. Our first question is from Brian Bittner from Oppenheimer.

Brian John Bittner ***Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst***

I hope you all are doing well and staying safe. Can you help the investors in the United States just better understand -- who are not in China, better understand what type of consumer trends you're seeing in your store base that are not located in the transportation hubs? I understand the transportation locations are challenged given the transportation trends. But overall, you've already recovered 94% of your pre-COVID sales volume, so you're pretty close to a full recovery. So are you seeing a more clear path to pre-COVID sales levels in those markets that are outside the transportation hubs? Or is there still a lot of volatility and headwinds related to the pandemic in those more traditional markets?

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

Thank you, Brian. We are all staying quite safe in Shanghai. China is recovering quite smoothly despite not completely out yet.

Let me give you an overall picture about the Chinese New Year trend and then compare the KFC versus Pizza Hut and then a bit specific about the nontransportation hub. Hopefully, that gives some ideas about what's going on here.

So let's start with the Chinese New Year. We had a lot of uncertainties before going into Chinese New Year because the trading was a bit soft. And what our company has done is to prepare, have quite a few scenarios planned so we react quickly. And as we adapt to the market condition, the trading picked up during Chinese New Year and was robust. But after the Chinese New Year, we continue to see

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some weaknesses in trading, particularly in transportation hub.

Outside transportation hubs, to answer your question, the dine-in volume is still well below the pre-COVID level. That's why we remind our investors that we are not out of the woods yet. But what can we do? We stay agile, and we plan for the possible scenario. So that's point one.

In terms of point 2, which is a big picture of KFC versus Pizza Hut, we are happy with both brands' recovery because the Q1 results show the resilience and the energy of both brands. The sales was disrupted, but with the scenario planning, the year-on-year same-store sales for KFC, Pizza Hut, and I'm referring to 2 years, so pre-COVID-19 level, KFC was minus 6%, which is 94%, and that includes the impact of the transportation hub. Pizza Hut recovered to 95% compared to 2019 Q1, without much of the transportation hubs in their store portfolio. So that gives you a sense because 2020, the numbers are unusual.

And then when we look at the system sales, the Pizza Hut, compared to 2019, is still minus 2% because Pizza Hut did not open that many stores last year, although we are picking up in Q1. For KFC, system sales recovered to plus 6% versus 2019 because we opened a lot of stores last year. So I hope that gives a sense that it's not -- with or without the transportation hub, the same-store sales is still having a little bit gap versus 2019.

So come to the -- a bit more specific about the trend and the trading. Andy talked about the transportation hub business, it's still 40% down compared to 2020. And that's the traffic. And in terms of sales, it's pretty much in line, although we do slightly better than the traffic number.

And then in terms of city tier, I'm talking about KFC because KFC store cover 1,500 cities in China -- over 1,500 in China. So that gives a better big picture of what's going on here.

The lower-tier cities have better sales, same-store sales than the higher-tier cities, mainly because the higher-tier city stores have the element and mix of transportation hub stores. And then the delivery growth is better in lower-tier cities.

And the eastern part and western part China led the recovery. Northern part and northeastern part of China, because of the regional outbreak, they have been a bit softer. And then weekend and weekday, our traffic is pretty much back to where it needs to be or where we want it to be because we have had a bit more promotion to drive the weekend traffic, which was a bit soft before, but now it's back to pretty normal. And then for the nontransportation hub stores, just single out these stores, it's about 2% gap versus 2019 or pre-COVID level. So Brian, I hope that gives you a comprehensive view of the trading.

From consumer behavior point of view, they are still quite value cautious, and therefore, we still have to be mindful about the value that we can pass on to consumer. But that's not the only thing they want, they still want new products. So other than value, we still launch new products to make sure that we encourage the customer to come back.

So I'll pause here. And Andy?

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

Yes. I just have a couple of things to add there, Brian. I think for the folks outside of China, I think it's important to keep in mind that we're still facing quite a bit of uncertainty and challenges related to COVID-19. So even though like things seems to have calmed down a lot here, we did have a regional resurgence at the end of last year and beginning of this year, right? So they have an impact on our first quarter trading.

So -- and then when we look around, I think we still have quite a bit of health preventive measures that is still in place, so that was still -- and the government will continue to remind folks to say alert. Not to be alarmed, but stay alert on the COVID situation. And as we look outside of China, and then we have seen resurgence in some other countries in Asia, including Japan, and more recently, the situation in India. So that reminds us that like we're not out of the woods. So still a lot challenging -- challenge ahead.

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As Joey mentioned, obviously, transportation hub is an important business for KFC, they account for high single digit of the sales. So that will continue to be sort of like a challenge for them to overcome -- to reach that fully recovered SSG compared to the pre-COVID level.

Same thing for the dine-in, right? Dine-in, I think, in the first quarter, where traffic was still at about 87% level [outside] the pre-COVID level.

Our delivery business is doing fantastically well, right? So grew very strongly last year. I think this year, we're still growing at mid-double-digit number, right? So that continues to be a bright spot for us. So we did compare it to pre-COVID level, obviously, grew more than, I think, 60%, 70%, right? So that's like the overall situation right now. Thank you.

Operator

Our next telephone question is from Chen Luo from BofA Securities.

Chen Luo ***BofA Securities, Research Division - MD***

I've got a question on the margin side. So it seems that Pizza Hut posted pretty strong margins for Q1 this year. And in fact, if my -- correct -- or my calculation is correct, it should be the highest ever since 2018 or when we started the revitalization process. So what's our future strategy with regard to Pizza Hut in terms of balancing margins and same-store sales growth, is it fair to say that the future margin trend of Pizza Hut could be above the level that we saw during the past few years when we are in the process of revitalizing Pizza Hut?

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

Chen Luo, this is Andy. So let me try to address your questions and then see if you have any follow-up. So I think if you look at Pizza Hut, obviously, we're very pleased with the execution there. I think over the past couple of quarters, they have demonstrated that they have executed their revitalization program really well, and then they are building on that resiliency, right?

So I think some of that -- those, as we mentioned before, obviously, is improvement. I think if you look at the fundamentals, we continue to look at that improvement based on the fundamentals that we would have laid out before, right? Store remodeling, menu, the food, we also work on the digitalization program, which worked out very well for us in the pandemics, right? We are able to get back very quickly. So -- and if you look at the digital number for tabletop orders, it's quite incredible right now. It's almost (inaudible) of that.

So I think they have -- did a very good job in revitalizing fundamental. We still -- I mean, the recovery is quite strong, but I think -- I don't think we can say like -- as a whole company, we cannot say that we are out the woods compared to pre-COVID level. So the top priority for them still is driving traffic, and we're glad that for the first quarter in 2021, we see actually, the traffic increase not only year-over-year, but also compared to the 2019 level in the first quarter.

So the next one is obviously driving that sales number, and so there's still some work there. And I think we will continue to emphasize on value for money. Value, as Joey mentioned, very important for consumer now in a -- when they as they're coming out of the impact from COVID-19.

So again, we are pleased with the progress in cost control, executions? But I think profit is still not the #1 priority for us. For Pizza Hut and also KFC, obviously. It's to drive the store traffic, drive the consumer back to the store and then aim for that full recovery in same-store sales compared to pre-COVID level.

But I think like if you look at Pizza Hut, some of the improvement will definitely continue. And some of that, as we mentioned before -- for example, as we see the poultry prices. The poultry prices are going up, that's in second half of the year. As the year progresses, we may see inflationary pressure there.

Both brands are doing packaging improvement, right, transitioning from plastic to eco-friendly materials, but also investing more into packaging for upgrade, for delivery and also for takeaway products. That would also be somewhat of an overhang there.

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Labor productivities have -- we have gained a lot of labor productivity improvement using technologies, AI tool that we've enabled to the restaurant operation. But some of that is sort of like due to the labor shortage that we have seen in the second half last year. We have mentioned that. We continue to try to resolve that. We are looking into increasing the staffing level, make sure that we continue to maintain a high level of customer services, and that's very important in the long-term viability of the brand.

So those are the couple of things. And then again, like if you look at the overall margin front, last year, we received $100 million from government relief, right? So this year, it's already phasing out. We have $6 million in the first quarter, and we will expect that to continue to phase out as the year progress. So all in all, so we still have some positive, and then we also see some headwinds in terms of margin and cost.

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

I think I just want to add 2 comments. One is we have been very consistent with the path of recovery for Pizza Hut since the time we commit to turnaround. We have always been very clear about our priority, which is sales first, profit later. And we focus on improving the fundamentals of the business in the last few years, and we are grateful that we are seeing the results. So that's point one.

Point two is, what is next? The next is to focus on improving all aspects of the changes that we made in the last few years. And cement the changes to make Pizza Hut a resilient business model. That's what we want because that's what we have been trying hard to achieve for KFC, which is a very resilient business, and we want Pizza Hut to be a resilient business model as well.

And at least in 2 aspects, we want to continue. One is sales first, profit later, that's the path in the last few years. Next, we want both sales and profit. As I mentioned on other occasions before, sales is vanity, profit is sanity, and we want a bit of both.

Second, the second aspect of the resilient business model, you can see we have been increasing building our off-premise business. So now between the delivery and takeaway, the off-premise business is over 40% of the business. And this is important because we are not relying too heavily on dine-in business. It's much better to have dine-in, delivery and right now, takeaway or ready-to-cook product as well. 4 pillars of the business instead of 2 pillars. So these are 2 examples of resilience that we are looking for. Thank you, Luo, Chen.

Operator

Our next telephone question comes from Michelle Cheng from Goldman Sachs.

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

My question is about the occupancy and other costs. We actually noticed that this cost line has been a huge savings in the past few quarters. So can you give us more color on the breakdown? And also more specifically on rental ratio. We heard from other like leading restaurant trends, they have a pretty favorable rental term post-COVID. So just wondering that compared with the pre-COVID level, are we also seeing a good rental saving? And how sustainable these other cost savings can be seen in the next few quarters?

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

Michelle, thanks. This is Andy. So regarding your question on O&O, I think you're right, like we've seen quite substantial improvement coming from the O&O segment, 7% year-over-year, lower, and then roughly 1.4% lower than 2019 same period.

I think as you can see, these 2 numbers, O&O in the big part is driven by sales leverage. So that's the most important factor that's driving that. The other one is that if you look at utilities, there's 2 things that's going on there. I think over the past few years -- so the government have sort of reduced the utility cost to basically try to improve the business environment, especially during the pandemic, so that will also help. How long this will last? I think maybe end of the year or early next year.

The other one is, obviously, over the past couple of years, we have tried to improve our kitchen automation and operations. We have mentioned smart utility device that we have installed in some of the stores, a simple procedure, so that also lowered that. And then also, we mentioned that some of the saving is due to rent relief, temporary relief and some of the government relief in terms of social security payments and whatnot. So that, I think, in the first quarter, we still have some $6 million.

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So all these combinations help us sort of improve that to -- as a percentage of our sales. But I think -- so I think some of those is carryforward. But a big part of that would probably have to do with the sales leverage that we experienced.

Operator

The next telephone question is from Anne Ling from Jefferies.

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

I have questions regarding the operating -- the leverage. It's a very good margin that we have experienced in the first quarter. I'm just wondering like whether there is any like -- not one-off, but it's like a catch-up because the sales have been so strong. So there are some of the investments that we need to do it, but because of the time shift that we -- I mean, the question I want to ask is that what should we be expecting in terms of the operating margin in the coming couple of quarters? Is that some of the other investment that we need to play a catch-up because -- because like first quarter was so good that there are some of the costs that might have left behind? So that's my question.

And also a side question is on the delivery side. If we -- with this effort in terms of sharing the riders between Pizza Hut and KFC, in that case, in the past, we have -- we talked about a little bit of the margin dilution for the delivery business. With all these like exercise, do you think that at some point, our margin for delivery business will be [apart] to the dine-in, given the fact that the sales mix is getting higher and higher on the delivery side?

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

Anne, this is Andy. Let me try to address your questions about some of the one-offs and whatnot. So obviously, I think like last year, we have received government subsidies and whatnot. And then as you mentioned, so that is continuing to be phased out. In the first quarter, we have $6 million. I think that will continue to be the trend there.

The other part is that for the cost of sales, for example, we were -- I think after a couple of years of rising of protein and commodity prices. Beginning of second half last year, we begin to see that easing up. We benefited quite a bit in the first quarter. We see a 7% year-over-year decline in the poultry prices, for example.

But as you have probably noticed that on the news, like when we see corn prices, all this feeding stock that prices are going up. We're already seeing like the protein prices going up, both here in China but also overseas. Our contract is locked up probably 1 to 2 quarters ahead of time. But we -- as we mentioned, we will see that tailwind beginning to subside as the year progress and potentially and likely potentially turn into inflationary pressure later on this year.

The other one is, obviously, we have embarked on the phasing out of plastic. So -- and then as we see delivery and takeaway as an increasingly important part of our business, we are also investing into improving the packaging for those operations. So you will probably also see like the packaging costs would go up as the year progresses as we continue to roll that out.

In terms of labor, I think this -- part of that is obviously labor productivity that we have been ongoing for a number of years now. Is -- the goal is really to continue to see that level of improvement by providing new technologies and tool kits to improve that production operations.

I think there's 2 issues there. One is that we did experience some labor shortage since last -- second half last year. As I mentioned, we tried to rectify that and then tried to step up the hiring. But I think we still have not -- at the level that we would like to see, so we will continue to drive that.

The other one is obviously wage inflation. As the economy -- as the pickup, as the pandemic impact subsides, as we mentioned, we had some restrictions by government into mobility for some of the part-time workers. But overall, I think the labor market will be getting tighter and tighter. And then we're likely going to see the wage inflation potentially also stepping up. And then that is a -- you have to remember that it's compounded for 2 years, right? so that's a headwind that we had worked through.

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For delivery, I think it's not always necessarily a -- it's a more complicated story for the margin because we need to look at, holistically -- obviously, we have the delivery cost that is add up to it. But we also -- to see if we can improve our operation inside the restaurant, right, to improve margins. So if you look at our margin, for example, before the pandemic, you see that the sort of like COL margin relatively stable despite our delivery volume or percentage mix of sales increase from, I think, 6%, maybe in 2016 to almost like 30% in 2019. So we are able to find a way to offset that increase in delivery costs. So we'll continue to do that as we invest. But that will likely continue to be pressure, but we're trying to find a way to offset that.

So that's overall. So I think like -- I know we have delivered a very strong profitability, and we are very proud of our team in the cost control. But you're right, like in -- going into the next few quarters, we're going to see some headwind in terms of cost and et cetera.

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

And I just want to add 3 points to Andy's comment. In terms of cost side, we continue to work on, of course, such as the Delivery 3.0 upgrade with rider platform upgrade, AI-enabled zoning, rider routing optimization that helps.

But I really, really want to point out point 2 and point 3, these are the other aspect of the equation. Point 2 is about the sales upside during peak trading period and peak trading hour. If we can have enough riders, we actually have more sales upside during the peak trading period and peak trading -- and Chinese New Year is a very good example. So it will be a bit misleading to ourselves if we just look at the cost side. So that's point 2.

Point 3, the thing about this, when Andy said earlier it's a holistic approach. It is a holistic approach. It's not necessarily that straightforward to think that having more stores help the delivery cost. But indeed, it was that way. And when we increased the store portfolio density, then we reduced the average circle of delivery distance. For example, when we have more stores, we can reduce the delivery distance of the rider from 5 kilometers to 3 kilometers, and that reduced the cost. So it's not only just the cost. We have other -- quite a few aspects that we can do to both increase the sales and to manage the cost. And our number has shown that we have we have been able to do that in the last few years. Thank you, Anne.

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

And this is Andy. I want to add a little bit on Joey's comments. There's 2 things. One is as Joey correctly point out. If incremental sales, the profit margin is much higher, right, opposite incremental margin, (inaudible) would be higher. The other one is that in terms of the rider network effect, it's a very interesting thing that I think we're still wanting to see how the dynamics work, right? The high -- you have high density network. That's enabled by the fact that we run our own delivery network. We have a hybrid model. We work with [the aggregator] with the traffic and our own app. But the delivery, we manage that operation ourselves. We have dedicated rider, so we can continue looking to improvement on the network factor, the benefit from that. So that may be a little bit different from the U.S., restaurant operators and someone who operates most -- restaurant operator here in China. We want to be (inaudible).

Operator

Our next telephone question is from Lillian Lou from Morgan Stanley.

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

Yes, I have actually one of the follow-up questions because most of the questions were answered. That's still about the comment that Joey just made about the -- to look at the business on the holistic approach.

So compared to a couple of years ago, when delivery was still a relatively smaller amount of the revenue, right now it's close to 30%. And also, the store network in the lower-tier cities, the density is actually higher. Compared to then, what kind of margin impact to this kind of dynamic changes? In particular, like delivery, we know that it's still probably -- it depends on the calculation, it's probably still margin dilutive. But compared to a couple of years ago, what kind of margin impact of this delivery and also lower-tier store changes to the margin? And what kind of projection we can make for the next couple of years? Will it be incrementally positive to margin?

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

Okay. Thanks, Lillian. This is Andy. Let me take a crack at this and then maybe if do we have more, Joey can add a little bit more later.

In terms of delivery, I think it's -- I don't know if it's fair to say the delivery margin is dilutive to the overall operations. As we mentioned before, like we generally look at the restaurant operation holistically, right? So we have multiple ways of delivering the product to our customer, i.e., dining, takeaway and delivery.

Now it's important to look at, obviously, the restaurant margin for us -- because the food is unlike e-commerce, right? E-commerce, you don't need -- you just need warehouse and you can distribute it to the consumer. Food you need to deliver to consumer at a certain time, right, to ensure quality of the food and then customer satisfaction. So having a production or restaurant location is almost a must.

For us, if you look at the delivery, delivery has been growing very rapidly. I think we believe that, that's incremental to our overall sales. And then the other part is that if you look at overall restaurant margin -- for example, for KFC before the pandemic, it was relatively stable, right? So it's about 18% in 2017, '18, '19. And then we are back to a sort of similar level in the first quarter this year. So all through this period, obviously, delivery has been increasing. As I mentioned before, about -- delivery was about 11% of our sales in 2017, and now it's about 30% plus, right?

So we're able to maintain that margin. Obviously, it's hard work. There's a lot of -- and we're going through it, but it hasn't been particular dilutive to us. The other one is that if you look at, for example, the labor cost expenditure, for example, for KFC, like for example, it has been also relatively stable despite also, we continue to see wage inflation in China at -- before pandemic to high single-digit level, right? So if you look at KFC's cost of labor, which including the rider cost there, was about 20%, 21%. It's stable in 2018 and '19, both relatively speaking is probably '21, '20, yes -- or 21%, right? So -- and then in this year, we had about 22%.

So overall, I think, as Joey mentioned, it's not necessarily dilutive for us. If these incremental sales come bring in by delivery, we actually have higher margin because the marginal contribution from additional sales is actually pretty high.

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

Thank you, Andy.

I just have one more point to add, Lillian. Actually, the shift to the delivery business actually helped our rental percentage as well, just maybe bring that into the equation. Why? Because if a store is relying too heavily on dine-in business, the location cannot be compromised too much. It has to be very, very good location. Otherwise, you don't get the business. But when we are building more and more delivery-friendly stores, relying more and more on delivery, we actually open up more opportunity for locations that are at slightly lower rent. And that's not a small deal for us. So as we expand our store portfolio, moving towards delivery, certainly, it helps. Okay. Thank you, Lillian.

Operator

Our next telephone question comes from Christine Peng from UBS.

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

I just have one quick question regarding the outlook provided by the management earlier. So you mentioned about there are still some uncertainties in China regarding COVID-19 situation. But having said that, we actually observed a very strong pickup in the domestic traveling activities, especially going into the Labor Day holiday. So can you maybe give us more color in terms of the sequential trend you're observing in China in the past 1 or 2 months, so that investors can get a better feeling in terms of what is the expectation we should be setting for the upcoming 1 or 2 quarters same-store sales recovery compared with pre-COVID-19 level?

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

Christine, this is Andy. So I think you're correct that like if the domestic travel volume have picked up quite a bit, I think this year and especially spring festival and potentially going into the Labor Day holidays weekend. So that's the overall traffic volume side. I think that -- but the difference is that the consumer behavior still remain cautious. So if you look at the trip that they say is generally are shorter

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trip. So if you look at overall spending level, it's still down, I think, quite significantly, probably down 40% plus compared to pre-COVID level, right?

So I think there's 2 things that we need to separate, right? The trip that they will take, but the type of trip that they take may be different and also the spending level is different. And I think that is similar to what we observed before, right? Like Joey mentioned, generally, when we see there's some pent-up like -- sort of like urge to go out and to -- when there's a holiday, right, to relax, but so we see that sometimes the holiday day sales will be relatively strong. But then there's post-holiday season sort of like softening. People generally still are cautious about the COVID situations and then also the economy -- economic situations, right? So that's -- always introduce a level of uncertainty for folks. So that's what's going on here.

Like I think if you look at the overall situation, it's much better compared to 2020, obviously, in terms of like COVID situation, even compared to -- obviously, we -- but again, as we have mentioned before, we need to stay alert. Not to be alarmed, but alert. The reason is because if we look at -- in China, we have a mini resurgence of COVID situation in the end of last year and early January. So when things calm down, I think it's easy for folks to think like everything is back to normal. But I think the reality is that we're not.

We also -- I think what's happening internationally, it would also have an impact on the overall consumer segment here. We have seen the situation in India. Our hearts go out to the folks in India that's impacted by COVID-19. It's a constant reminder for us that we are not out of the woods. We need to -- we continue to expect the recovery -- the full recovery to be nonlinear and uneven. And it's just not a thing. I think it's our firm belief, and this is how we operate and plan for different scenario or different situations. And we encourage analysts and investors to do the same, not to extract it linearly, a linear extrapolation. And -- but that's how we plan. That's why we say the full recovery of our same-store sales take some time. Thank you.

Operator

And our next question is from Lina Yan from HSBC.

Hau-Yee Yan ***HSBC, Research Division - Hong Kong and China Consumer Analyst***

Thanks, management, for the very detailed analysis on your performance. I have a question regarding the base effect of sales at the traffic hubs. I think you started to talk about the very negative growth in the traffic hubs from second quarter last year. So it has always been high single digit of your sales, like from second quarter last year. So would you comment that the base for traffic hub sales will become more favorable from second quarter onwards?

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

Yes, likely, right? So because we have a big impact, obviously, at the lockdown, I think last year in the beginning, in the first quarter, and then we see a rebound in the traffic over the year. But I think the volumes still significantly below the pre-COVID level. So I think on a year-over-year basis, you will see improvement. But on a 2-year period compared to pre-COVID level, I think it will take quite a bit of time for a full recovery. And then obviously, we're encouraged by the fact that (inaudible), the situation here in China is relatively calm after the resurgence in December and also in January period.

So -- but I think it would -- more impactful for KFC because you have more stores in the hubs -- in the transportation hub location. The other part is that international, we -- don't forget, we have international locations. So international travel is still pretty much immaterial right now, right? So until country open up border and we see international travel, that will continue to be a big overhang on the transportation hub.

Hau-Yee Yan ***HSBC, Research Division - Hong Kong and China Consumer Analyst***

Okay. So I think every comparison is referred to a 2-year comparison basis?

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

That's right. Yes.

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Operator

There's no more further questions at this time. I'd like to hand the call back to the speakers for closing remarks. Please continue.

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. This concludes today's call, and have a great day. Thank you.

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

Thank you. Bye-bye.

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

Thank you. Bye-bye.

Operator

Thank you all. You may all disconnect. Have a great day. Goodbye.

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